CHAPTER VI

ISRAEL AND THE WORLD ECONOMY

1. Main Developments

Two interrelated processes can be readily identified as the outstanding economic developments of 1974: the impact of the oil price revolution unleashed by OPEC at the beginning of the year, and the slide of the largest Western industrial economies (especially the U.S., Germany, and Japan) into their deepest recession since the Second World War. The interrelationship consists in the fact that this slump was brought about primarily through the additional cost-push pressure exerted by the oil and commodity price rises in the face of tightening monetary and fiscal policy. Other major events essentially reflect this dominant development, namely:

(a) The steep downswing of most commodity prices from their extraordinary peak levels of early 1974 (with the exception of food, whose fall was delayed by poor harvests until the last months of 1974 and the early months of 1975).[1]

(b) The much-heralded buyers' market in petroleum (i.e. the surplus of production over shrinking demand), which, so far at least, unfortunately appears to reflect primarily the depressing effect of the world recession, rather than effective substitution, upon the demand for oil.

(c) The weakening of the U.S. dollar in the second half of 1974 (and in early 1975), after it had strengthened for a time owing to the expectation that the U.S. would suffer less severely than other countries from the effects of the prospective oil deficit. The unexpected downturn in fact reflects primarily the rapid fall in rates of return in the U.S. (both interest and profit) relative to European centers, as the U.S. economy slumped more deeply than others. This factor, combined perhaps with some noneconomic factors, has apparently resulted in a smaller flow of OPEC funds to the U.S. (or to dollar investments) than expected—smaller in fact than the increase in the U.S. oil deficit on current account. It has, of course, also increased the net outflow of other funds.

2. Impact on Israel

Although developments in the Israeli economy have been dominated by rather

[1] See Figure VI-4 below.

Table VI–1

GROWTH OF REAL GNP IN OECD COUNTRIES, 1960–74

(percent change at annual rates)

	Average 1960–72	1973	1974	1973 2nd half	1974 1st half	1974 2nd half	1974 4th qtr.
Canada	5.0	6.8	(3.7)	4.5	5.6	(−1.4)	5.0
U.S.A.	4.1	5.9	−2.2	1.9	−3.4	−4	−9.0
Japan	11.0	10.2	−3.25	2.8	−9.0	(3)	−1.6
France	5.8	6.0	4.75	5.4	4.5	4.25	3.1[a]
W. Germany	4.9	5.3	(0.8)	0.5	2.0	(−1.7)	−5.0
Italy	5.5	6.0	4.75	9.4	4.9	0	—
U.K.	3.1	5.3	−0.5	0.3	−3.4	5	5.7[a]
Total of above countries	**5.5**	**6.5**	**(−0.5)**	**2.6**	**−2.0**	**−1**	—
Other OECD countries	5.3	5.0	3.25	—	—	—	
Total OECD							
Incl. U.S.A.	**6.3**	**6.6**	**(−0.4)**	**3.0**	**−1.3**	**(−1.5)**	—
Excl. U.S.A.	**5.4**	**6.3**	—	**3.7**	**0.1**	—	—

[a] Third quarter.

SOURCE: OECD countries — Organization for Economic Cooperation and Development, *Economic Outlook*, December 1974. The figures in parentheses have been corrected for later data from the Federal Reserve Bank of St. Louis; the data for the fourth quarter of 1974 are from this source. The figures for those countries (and the totals) for which no fourth-quarter data were available (e.g. Italy, France, U.K., and all smaller OECD members) are probably upward-biased. The data for the U.S.A. for the second half and all of 1974 are from the U.S. Council of Economic Advisers, *Annual Report*, February 1975.

drastic domestic policy steps, the international changes described above inevitably have had significant consequences as well. These lie primarily in three areas: (a) income effects abroad on Israel's exports; (b) the effect of the dollar exchange rate movements upon the average external value of the IL (which have affected both the average formal rate, used for capital movements, and the average "effective" rates for trade; and (c) the effect of commodity prices (and other price developments) upon the country's terms of trade. Each of these topics will be discussed briefly in this chapter.

The dominant forces affecting Israel in 1974 were the result of the interaction between internal policies and the world economy. Thus the country's balance of payments fell into substantial deficit during most of the year, above all, because of the sharply negative effect of the oil price rise on Israel's terms of trade and hence on its import surplus (this accounted for at least $400 million of the roughly $1 billion rise in the current deficit). This effect was shared with other oil importing countries. The expansion of Israel's current deficit was not, however, balanced by a rise in

Table VI-2

GROWTH OF ISRAEL'S EXPORT MARKETS,[a] 1966-74

(percentages)

	Developed countries	Others[b]	Total
1966	7.7	7.5	7.7
1967	5.3	4.6	5.2
1968	13.8	12.2	13.6
1969	10.7	10.4	10.7
1970	7.9	10.3	8.3
1971	6.3	9.9	6.8
1972	10.4	34.6	14.2
1973	11.1	4.3	9.9
1974	1.5	-1.4	0.8

[a] The measure of market expansion is the rate of quantitative increase in the total imports of the countries of destination, weighted by each country's share in Israel's exports (excluding diamonds).

[b] For lack of data the figures for 1972 onward relate to a very limited number of countries.

capital imports. Rather, its net capital imports stagnated despite the favorable effect of a number of economic factors (a slightly higher rate of real economic growth in Israel and a higher rate of interest). Statistical analysis shows that a great deal—but not all—of this effect can be attributed to the speculative influences arising from expectations of a change in the formal rate of the IL (which is the effective rate for the country's capital imports). This was reinforced in the current account by a corresponding shift in leads and lags, in expectation that devaluation would alter the effective rate for trade as well. Capital inflows, however, fell by more than can be attributed to this factor alone; both the security situation and bearish growth expectations probably explain the discrepancy, although we have no separate measure of the influence of each of these factors. The devaluation expectations, in turn, were the result of both the excessive rate of inflation in Israel over the last three years and the consequent widening of the gap between the effective and formal rates and the soaring of the overall deficit (and loss of reserves), itself due to the commodity and oil price boom. This gave rise to a familiar vicious circle in the system of pegged rates, in which the existence of a deficit reinforces the deficit itself through speculative influences. In line with this development, the actual implementation of the devaluation of the IL (43 percent formal, about 27 percent effective) led to the reversal of this factor. Changes thus induced (in both the current and capital accounts) converted the steady fall in reserves (by about $80-100 million a month) into a rise, which was considerably reinforced by more or less special factors.[2]

3. Outstanding International Developments

(a) *Recession in the largest free economies*

The speed and depth of the decline in real output in the seven largest Western economies (members of the OECD) may be seen in Figure 1.[3] From an extraordinary peak of 8 percent in the first half of 1973, the growth rate fell to 2.6 percent in the second half, −2 percent in the first half of 1974, and at best "recovered" to −1 percent in the second half of the year. Even this dramatic slump obscures the more drastic decline of the largest economy, the U.S. (with a weight of about one-third of the entire OECD), and of the second largest, Japan. As Table VI-1 indicates, real GNP in 1974 was down 2.2 and 3.25 percent in these two countries respectively. In Japan the fall was somewhat smaller in the second half as a whole (due to an unprecedented oil shortage-related slide in the first quarter), but it was still accelerating in each quarter. The U.S., after well over a year of low or negative growth, registered a much more serious contraction in the last quarter of 1974, which continued at about the same annual rate (−10 percent) in the first quarter of 1975. (The fall persistently exceeded advance forecasts and estimates, such as those of the OECD in July and November.)

The other main countries exhibited a generally "sympathetic" downward trend (particularly in the last quarter). France marked up the best performance for the second half as a whole, but various signs (e.g. the industrial production index) suggest that its growth rate also began to flag seriously in the last quarter.[4]

diplomats, U.N. personnel, and others. Vehicle imports by these groups, however,

[2] It is difficult (especially at this stage) to judge the degree of independence of the special factors from the effects of the devaluation. Thus, short-term credit flows to Israeli banks have grown greatly, but the devaluation also increased the willingness of foreign banks to lend. Other postdevaluation "special factors" (such as the IMF oil facility and credit tranches of $130 million) do not all represent net increases over and above similar "special factors" in the past. Moreover, they cannot account for the bulk of the improvement, which consists not simply in the rise, but in the turnabout from a sharp fall to a similar growth of reserves (i.e. about $956 million from November 1974 through March 1975). It should also be noted that because of the normal lag between the placing of orders and delivery, physical exports and imports could change significantly only three or four months after the devaluation (and this in fact is reflected in the March 1975 trade figures).

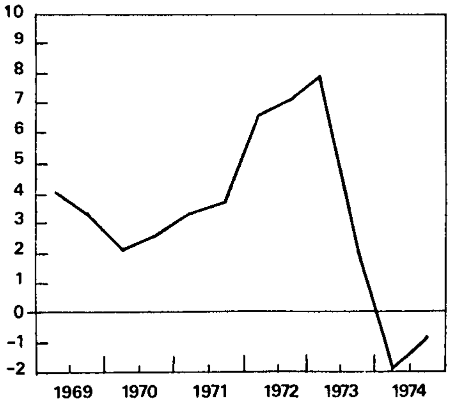
[3] See also Tables VI-1 and VI-2 below.

[4] The U.K. figures were greatly distorted by the effects of the coal strike in the first half (and the concurrent deliberate reduction of the work week).

Figure VI–1

REAL GNP GROWTH IN SEVEN MAJOR OECD COUNTRIES, 1969–74

(percent change from previous half-year, at annual rates)



It is perhaps noteworthy that most of the smaller OECD economies were more successful in maintaining stable growth, at least throughout most of the year, than the seven largest. As Table VI-1 shows, they achieved an aggregate growth rate of about 3.25 percent, compared with a negative rate for the larger countries. They therefore diverged from the usual pattern of close correspondence with the larger countries and exhibited a greater ability to control such crucial variables as wage-push without relying simply upon deflationary monetary and fiscal policies. This appears to reflect a more developed system of wage-price linkage or incomes policy (e.g. Sweden, the Netherlands, Norway, New Zealand). Nevertheless, most of these countries too showed signs of a serious downturn in output in late 1974—partly, no doubt, as the direct result of reduced export demand from the largest nations.

4. Fundamental Factors in the Decline

The current recession is, of course, highly complex in detail and varies in form from country to country. A careful consideration of each separate case (which could provide suggestive and useful insights) is beyond the scope of this survey. But the crux of the problem (i.e. the primary source of the international slowdown) may be described as a relatively straightforward process, namely the collision of cost-inflation, arising from steep relative increases in commodity and oil prices, with distinctly deflationary aggregate demand policies in the largest (and in some of the smaller) economies. The onset of this process was described in the 1973 *Annual Report* (Chapter III). Developments since then have only served to clarify and substantiate the diagnosis.

Essentially the problem arose from the relative downward rigidity of prices and wages in many sectors of modern economies (particularly in industry and services). As a result, when in 1973 and 1974 steep relative rises become inevitable in the

Table VI-3

SLOWDOWN OF OUTPUT AND PRICES IN U.S.A., 1973–74
(percent increase)

	December levels		1974, at annual rates				Monthly rate			
	1973	1974	I	II	III	IV	Sept.	Oct.	Nov.	Dec.
Consumer price index										
(seasonally adjusted)[a]	8.8	12.2	14.2	10.3	14.2	10.1	1.2	.9	.9	.7
Wholesale prices (SA)							–1.9	5.1	2.5	–2.5
Food	26.7	11.0								
Industrial	10.7	25.6	30	33	26	8	1.0	1.1	.9	0
All goods	15.4	20.9					.1	2.5	1.2	–0.5
GNP fixed (1967) weight price										
deflator of personal consumption			14.6	12.0	12.3	9.2				
Real GNP	5.9	2.2	–7.0	–1.6	–1.9	9.1				
Components of consumer price index										
Food			19.4	3.1	12.3	14.6				
Energy (directly purchased)			70.7	22.3	3.7	1.2				
All other items			8.6	11.9	15.3	9.6				

[a] Changes in the consumer price index are between the last months of each quarter. The quarterly consumption price changes and their breakdown give the clearest picture of developments. The sharp rise in the first quarter was due to the extraordinary jump in energy prices (of relatively small weight) plus a steep increase in food prices, while the weightiest element, "all other items", still lagged behind. In the rise of "all other items" through the third quarter can be seen the passing through of the earlier energy price increase. In the fourth quarter this abated. However, the renewed sharp advance of food prices in the third and fourth quarters maintained the overall consumer price rises of the first and second quarters. Monthly figures for the fourth quarter (and the first months of 1975) for food show that this support was lost after the fourth quarter and that the overall fall from the third quarter rate steepened. (President Ford's energy proposals, if passed, will of course offset some of this decline.)

SOURCE: U.S. Council of Economic Advisers, *Annual Report*, February 1975.

world market prices of raw materials, food, and oil (either because of a relative increase in demand, e.g. for raw materials, or a fall in supply—whether natural, as in the case of food, or artificial, as in the case of oil), the rate of general price inflation was quickly boosted to unacceptable levels.[5] The reaction of major governments, best illustrated perhaps by that of the U.S., far from easing demand policies so as to partly accommodate the additional cost-push pressure thus engendered, was to tighten monetary and fiscal policies further, as though combating a simple intensification of internal demand inflation.

The oil price revolution contributed several additional effects. Thus, the dampening influence of the shift of real income to economic units with a far higher propensity to save (the oil producers) was another factor which called for (but did not encounter) an easing of demand policy in the oil importing countries. On the contrary, in addition to tightening demand policy so as to combat the effect on their price indexes, many countries tended to tighten it still further, in preference to further exchange rate adjustments, as a means of curbing the rise in their payments deficits.

This applies most obviously to relative latecomers to the economic slowdown, such as Italy and France, and to those with exceptionally high rates of inflation (e.g. Japan and Italy). Thus, although the weight of the different motives is uncertain, some countries (the best example is perhaps France) did not seem unduly concerned about the higher rate of price inflation required to maintain full employment growth, until faced with the prospect of bigger payments deficits and falling currency rates (relative to the currencies of the more deflationary countries, such as West Germany).

While the precise contribution of rising food and oil prices to the increased rate of inflation is difficult to measure, it is easy to see that they can more or less account for the results observed, especially when an additional element of internal cost-push arising from the boost in wage claims induced by higher rates of price inflation and some degree of mark-up pricing are taken into account.

These remarks may be exemplified by developments in the U.S. There, the jump in oil prices set off a directly related comparable rise in coal prices. The direct advance in wholesale energy prices was on the order of two-thirds, and that of consumer energy prices about 36 percent for the year as a whole. This alone boosted the rate of consumer price inflation in 1974 by about 2.5 percent (and still more taking indirect effects into account). Also important for the U.S. was the impact of the continued soaring of food prices, and the working through of the steep rise in world raw material prices up to April 1974. The actual consumer price rise in 1973

[5] Tables VI-4 and VI-5 summarize basic information on price and cost developments in the major countries.

itself (from year-end to year-end) was already 8.8 percent (up from 3.4 percent in 1972). Thus, a rise to about 12 percent in 1974 is quite explicable.[6]

Against this combination of cost-push forces a contractionary monetary policy (the growth rate of M_1 fell from about 7.5 percent in 1972 to 6 percent in 1973 and 5 percent in 1974) was unable to arrest the rise in the rate of price inflation, but its effect on nominal demand was quite normal. The expansion of nominal demand slowed from 11.5 percent in 1973 to only 7.8 percent in 1974. To permit the greater rise in prices more than the entire decline had to take the form of a fall in the growth rate of real output (from 5 percent in 1973 to −2.2 percent in 1974).

With variations, much the same analysis applies to developments in other major industrial nations.

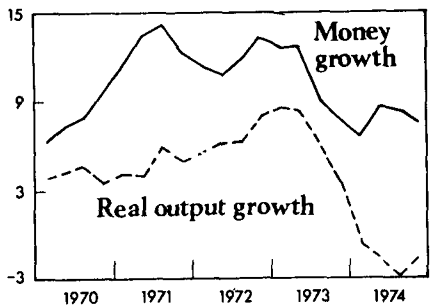
5. Monetary Policy and the Recession

As already noted, monetary policy abroad has played a crucial role in the development of the current international slump. A graphic idea of this can be gained from Figures VI-2 and VI-3,[7] which depict several salient developments—first of all, that a general fall in the money supply growth rate in 1973 preceded the sharp drop in real output growth in the major industrial countries. The discussion above suggests that the latter decline was magnified by the unusually strong cost-push forces generated by developments in energy, raw materials, food, and induced wage claims. However, this primarily affected the extent rather than the direction of the relationship between economic

Figure VI–2

GROWTH OF MONEY AND REAL OUTPUT IN TEN MAJOR COUNTRIES, 1970–74

(percent change at annual rates)

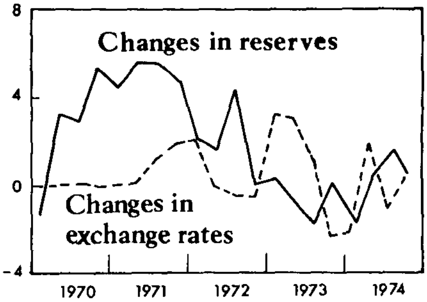


[6] Indeed, the net sum of such additional cost-push factors would appear to exceed the actual rise in the rate of inflation; this suggests that the heavy demand resistance did in fact squeeze profits, lower some prices, and generally keep the overall rate from moving up as much as it would have under conditions of full-employment real growth (compare, for example, the rise in France from 7 to 14 percent with that in the U.S. from 6 to 11 percent—Table VI-4).

[7] Computed by the First City National Bank of New York. The monetary growth rates in the major countries may be found in Table VI-6 below.

Figure VI–3

RESERVES AND EXCHANGE RATES IN TEN MAJOR COUNTRIES, 1970–74



SOURCE: First City National Bank of New York.

growth and the money supply. The latter is clear and relatively normal, as the chart suggests.

A second important development, which helps to explain this shift to a lower monetary growth rate, is reflected in Figure VI-3, which shows that both before and after the floating of the major currencies changes in the exchange rate of the dollar relative to the other currencies tended to be opposed by opposite movements in the official reserves of the other currency areas. The difference between the period of pegged and that of floating rates is one of degree.

Broadly, the chart suggests that efforts to support the dollar in 1972 contributed a great deal to the excessive rate of world monetary expansion that year (which set the stage for the inflationary world boom of 1972 and early 1973), while changes in reserves tended to dampen monetary growth in 1973 and 1974. This tendency to stabilize other currency values in terms of the dollar (and for some currencies in DM

Table VI–4

RISE IN CONSUMER PRICES, 1973–74

(percent change at annual rates)

			1974			
	1973	1974	I	II	III	IV
U.S.A.[a]	6.2	11.1	12.2	11.0	12.6	12.7
Canada	7.6	10.7	9.7	13.7	12.9	11.5
Japan	11.7	23.0	45.4	20.2	15.9	18.2
France	7.3	13.8	15.6	17.5	13.8	13.3
W. Germany	6.9	7.4	9.9	6.6	3.5	5.4
Italy	10.8	19.4	21.7	22.7	25.1	28.1
Netherlands	8.0	9.1	10.0	12.7	7.3	13.7
U.K.	9.2	15.8	17.4	25.8	11.8	19.2
Total OECD	7.7	13.3	16.0	12.5	12.0	14.5

[a] The differences between the U.S. figures in this table and those in Table VI–3 stem from the fact that the quarterly changes have been calculated here between three-month average indexes.

SOURCE: *National Institute Economic Review*, February 1975 for annual data and OECD quarterly totals; Federal Reserve Bank of St. Louis for quarterly data for individual countries.

terms) has usually brought other countries' monetary growth into line with U.S. and German monetary policy.[8] This clearly has its dangers, since these two countries have been among the most deflationary in the current recession. Recovery (and future stability) is more likely to be assured if other countries more fully exploit the advantage of monetary independence given them by floating rates rather than depend upon sufficient (or appropriate) stimulus from the dollar and the DM.

6. Dollar and DM Monetary Policies

The above general considerations should be supplemented by at least a brief analysis of monetary developments in the two leading currencies (the dollar and DM). While the growth rate of all monetary aggregates (M_1, M_2, etc.) in the U.S. continued downward throughout 1974, falling practically to a zero rate by year's end, in Germany monetary growth has been more complex, and after a marked slowdown the trend accelerated.

The principal influences in these developments appear to be as follows: In the

Table VI-5

PRICE AND COST PERFORMANCE OF SEVEN MAJOR OECD COUNTRIES, 1973–74

(percent increase over previous year; in local currency terms)

	1973				1974			
	Consumer prices[a]	GNP deflator	Hourly earnings	Export prices[b]	Consumer prices	GNP deflator	Hourly earnings[c]	Export prices
Canada	6.1	7.6	8.5	15.2	10.0	13.0	13	31.5
U.S.A.	5.5	5.6	6.8	16.1	11.5	10.9	11[d]	26.0
Japan	11.7	12.0	23.6	8.2	25.0	26.0	27	39.0
France	7.1[e]	7.3	12.4	9.5	13.75	10.0	19	25.0
W. Germany	7.0	5.8	10.7	1.6	7.5	6.5	11	14.5
Italy	10.8[e]	10.5	24.3	14.3	19.25	15.25	23	36.5
U.K.	8.6	7.3	12.6	12.9	14.75	11.0	16	28.0

[a] Implicit deflator of consumers' expenditure.
[b] Unit values.
[c] The fairly steep rise in hourly earnings in 1974 (over 1973) implies a new round of cost-push pressure arising from an internal source: wages, reacting to the earlier acceleration of price inflation. This factor worsens the stagflation syndrome in most countries.
[d] This figure (essentially a forecast based on half-year data) seems a bit high; the U.S. Council of Economic Advisers reports a rise of only 9 percent in employee compensation per man-hour.
[e] Consumer price index.
SOURCE: OECD estimates for December 1974.

[8] As shown below, the effect may reverse itself under extreme conditions of recession.

U.S. slow monetary growth (about a 5.5 percent rate in M_1) in the first half of 1974 was the result of a deliberate counter-inflationary policy. However, in the second half the rate receded even below that envisaged (to about 3.5 percent in the third quarter and near zero growth in December and January 1975), due to the feedback effects of an accelerating real economic decline upon the demand for bank credit. As is usual in the U.S., other monetary aggregates, such as M_2, diverged only slightly from M_1, despite higher interest rates, especially in the second and third quarters.[9]

In Germany, on the other hand, a marked slowdown in the expansion of the

Table VI–6

GROWTH OF MONEY SUPPLY (M_1) IN SELECTED COUNTRIES, QUARTERLY, 1973–74

(percent quarter-to-quarter changes; seasonally adjusted, at annual rates)

	1973				1974				1973 IV–1974 IV[a]
	I	II	III	IV	I	II	III	IV	
U.S.A.	7.0	7.5	5.6	5.1	5.9	7.5	3.9	3.8	5.3
W. Germany	7.2	–2.7	–8.7	8.9	6.8	8.2	11.5	16.2[b]	10.6
France	5.5	12.4	2.8	12.4	9.8	17.4	–3.2	34.8	13.8
U.K.	–1.3	29.7	–9.9	8.7	–10.2	13.8	11.0		5.4[c]
Italy	14.7	28.2	21.1	15.1	15.9	18.8	14.4		16.0[c]
Japan	28.7	32.3	11.6	8.4	14.8	19.9	5.0	5.4	11.1
Netherlands	14.2	4.3	–15.9	2.8	3.4	8.2	9.2	15.3	9.0
Belgium	15.4	13.1	5.9	8.3	11.3	9.4	2.6	11.0	8.2
Switzerland	–2.2	3.7	–3.1	3.9	–9.5	3.6	–4.3	1.4	–2.4

[a] Because of the lagged effect of monetary growth, these figures are mainly relevant to the outlook for the next year (1975). Fourth-quarter figures (and later data) show that Europe in general is leading the U.S. in boosting the monetary growth rate.
[b] Quarter-to-quarter average; the Bundesbank estimates the annual rate of increase in the fourth quarter at 26.3 percent.
[c] 1973 III compared with 1974 III. The U.K. figure reflects one of the sharpest average slowdowns (apart from Japan) — from a 14 percent long-run average rate to about 2.5 percent. However, the quarterly fluctuation is high, and the trend appears to have turned upward again in mid-1974.
SOURCE: Federal Reserve Bank of St. Louis.

[9] Within the U.S. institutional structure saving associations specialize in long-term mortgage credit and hence cannot adjust deposit interest rates flexibly. To protect these institutions, banking regulations prevented savings and time deposits from reflecting more than a fraction of the sharp boosts in short-term money market rates. It is primarily for this reason that M_1 and M_2 move more closely in step in the U.S. than in most other countries. It should be noted that in U.S. statistics M_2 excludes large certificates of deposits (CDs), whose interest rates are not restricted and whose quantity accordingly fluctuates more dramatically than that of time deposits.

money base ("Central Bank money stock", which equals currency plus minimum bank reserves) from about 10 percent to 6-7 percent since the second quarter of 1973 gave rise to widely disparate growth rates of M_1 and M_2. The initial impact was an extraordinary half year of negative change in M_1. (It is noteworthy that this began after the elimination of the dollar peg and the beginning of the joint float of several EEC currencies in early 1973.) The adoption of a tighter monetary policy was designed to slow the growth of all monetary aggregates after what was considered their excessive expansion under the impact of expanding dollar reserves during the previous period of resistance to a change in the dollar peg. This, however, led to an exceptionally sharp jump in short-term interest rates. Since in Germany, as in various other countries (e.g. the Netherlands) but unlike the U.S., such changes are allowed to work themselves through to interest rates on both small and large savings and time deposits, this brought about a relative shift from M_1 to time deposits, and hence the divergent trends of M_1 and M_2 in 1974.

Thus the growth of the money base by a fairly constant, quite low 6-7 percent coincided with a rate of about 9 percent for M_1 and of only 1-2 percent for M_2 in the first ten months of 1974.[10] At year's end, however, the growth of all DM monetary aggregates accelerated for almost the same reason that the rise of the dollar virtually stopped—the effect of the deepening U.S. recession. This led to an increased U.S. capital outflow, dollar weakness, and German reserve accumulation, given the tendency (noted earlier) for the German as well as other governments to resist the fluctuations of their currencies relative to the dollar.

The precise components of the fluctuations in the growth rates of currencies are less important than the overall result, since the aggregate change is, or should be, a function of policy. Broadly considered, the growth rates of the dollar as well as the DM (particularly when we take account of the latter's long period of negative growth in 1973) were insufficient to avoid the deepening of recession at home and abroad. The performance of the DM, especially as the year ended, at least gave hope that the German economy would avoid a slump of U.S. dimensions. But the short-run U.S. outlook at the time was still poor in view of the steep decline in the dollar growth rate.[11]

[10] Some loss of confidence in banks after the Herstatt collapse led to a shift from time deposits to currency, which also explains part of the M_1 - M_2 divergence.

[11] A monetary growth rate temporarily above the long-run trend is required to move the economy back toward its potential GNP (which in late 1974 exceeded the actual level by the staggering annual rate of some $200 billion or more). The rate in fact began to rise again (but weakly) in the first quarter of 1975.

7. Commodity Prices and Israeli Terms of Trade

The interpretation of the "stagflation" process given earlier leads naturally to the related subject of commodity prices, particularly of food. Evidence adduced by the U.S. Council of Economic Advisers indicates that the U.S. (and with it the world) has moved into a new period of much greater fluctuation in food prices. This is a direct, but unforeseen, consequence of the elimination of the large U.S. price supports and related stockpiles of agricultural commodities. (The stocks were eliminated partly as a result of deliberate U.S. policy and partly because of surging world demand, especially of the U.S.S.R. for U.S. food exports.[12]) The resulting boom of food prices in 1973 and 1974 was unprecedented only for the period 1950-72, which was dominated by U.S. food stockpiles. In fact, similar fluctuations were the rule for many decades before 1950.[13] The cost-push effect of this new food price instability (i.e. of the upward fluctuation in 1973 and 1974) on the U.S. economy is explained not only by the downward rigidity of most nonfood prices in the U.S., but also by a vast increase in the proportion of U.S. food output exported (and in the U.S. share of total world exports). This implies that U.S. food prices, always fairly insensitive to internal aggregate demand, have become almost exogenous with respect to this factor. Continued high variability in this sector also implies the possibility of an unusually rapid fall in the overall rate of U.S. and world price inflation (e.g. following one or two normal U.S. harvests—quite possibly in 1975). However, so long as the variability is not dampened by a new policy of large-scale stockpiling (possibly arranged on an international basis), it will result not only in a greater variability in rates of inflation than has become customary since World War II, but probably in somewhat higher average or trend rates of inflation. The latter conclusion follows from the ratchet effect arising from downward price and wage rigidity in industry and services (i.e. these prices can go up without hindrance in years when expenditure shifts from the flexible food or raw material sectors, but they hardly fall when expenditure shifts the other way).[14]

[12] Prior to 1972 the U.S.S.R. reacted to poor harvests largely by reducing internal food consumption. In 1972 and 1973 it attempted for the first time to offset a similar shortfall by massive imports. The U.S.S.R. has had exceptionally unstable food production and has accounted (according to the Council of Economic Advisers) for 80 percent of the variance in world food trade since 1960.

[13] For example, the annual variances of the farm prices of wheat, corn, and soybean (in constant dollars) were respectively 1.5, 3, and 10 times higher in 1910-49 than in 1950-71.

[14] The precise effect on the trend also depends upon the conduct of aggregate demand policy. Thus, in a year of deflated demand, such as 1974 (or 1975), the relative shift in expenditure from the flexible commodity sectors may not suffice to actually increase prices in

Table VI-7

ISRAEL'S APPROXIMATE TERMS OF TRADE IMPACTS, QUARTERLY, 1973–74

	1973				1974					
	I	II	III	IV	I	II	III	IV	1973	1974
1. Index of import prices	100.0	112.2	127.7	136.7	166.6	179.3	171.1	172.3	119.4	172.4
2. Index of export prices	100.0	111.1	120.6	118.8	122.6	134.4	133.3	134.9	111.7	131.3
3. Terms of trade index (2÷1)	100.0	99.0	94.4	86.9	73.6	75.0	77.9	78.3	93.6	76.2
4. Percent decrease from 1973	—	-1.0	-5.6	-13.1	-26.4	-25.0	-22.1	-21.7	-6.4	-23.8
5. Oil prices (1973 III = 100)			100	148	473	468	354	343		
6. Terms of trade "import effect"[a] as a percent of:										
Domestic resource use	—	-0.3	1.8	-4.1	-8.3	-7.8	-7.0	-6.7	-2.0	-7.5
GNP	—	-0.4	-2.2	-5.0	-10.2	-9.5	-8.5	-8.2	-2.5	-9.2
7. Terms of trade effect on national income (percent of GNP)[b]	—	-0.2	-1.2	-2.9	-5.8	-5.5	-4.9	-4.8	-1.4	-5.2
8. Percent change in (7) from 1973 to 1974										-3.85

[a] No single "true" estimate can be given of the effect of a faster rise in import prices on the purchasing power of capital imports. It depends upon the nominal growth of the latter — which also tends to rise with world price inflation. This calculation indicates what would happen if nominal capital imports rose in proportion to export prices (i.e. if the fall in the purchasing power of capital imports and that in export earnings were equal).

[b] This equals the change in the terms of trade (line 4) times 1972 exports (expressed as a percentage decline from 1972 GNP). It constitutes the reduction in the purchasing power of Israel's export earnings alone, and thus of earned national income, over imports — due to the worsening of the country's relative terms of trade. This effect must be deducted from the change in constant price GNP to obtain the true change in real (or constant purchasing power) national income. In principle, it equals the difference between the growth of GNP deflated by the GNP deflator and by the total resources deflator. In practice, discrepancies may arise due to statistical factors. (For example, national account deflators are indirectly derived from quantity and value series and include services. The import and export price indexes are Laspeyres indexes, based on 1973 weights and referring to trade in goods alone. Also, the deflator result reflects changes in the imports and exports in the national accounts after 1972; the above calculations do not.) Nevertheless, the extraordinary 1974 effect (shown by line 8) is quite similar in both approaches. It means the loss, through terms of trade deterioration, of most of the gain from real product growth in 1974, and more than all of the gain from the growth of product per capita.

Table VI-8

A. BALANCE ON CURRENT ACCOUNT OF MAJOR AREAS, 1973–74

($ billion)

	1973	1974	Change
OPEC countries	5.0	60.0	55.0
Industrial countries	2.5	–37.5	–40.0
Rest of world	–7.5	–22.5	–15.0

B. CAPITAL ACCOUNT DISPOSITION OF OPEC CURRENT SURPLUS, 1974

($ billion)

1. Investment in U.S.A.	11.0
Government securities	5.5
Real estate and private securities	1.0
Bank deposits and CD	4.5
2. Investment in U.K. banks and govt. bonds	7.5
3. Loans to other industrial country governments	5.5
4. Loans to developing countries	2.5
5. Loans to international financial institutions	2.5
6. Eurocurrency deposits	21.0
7. Investment in private industry and real estate — Europe and Japan	9.0
Total	**60.0**

SOURCE: U.S.A. — *Economic Report of the President*, February 1975.

Figure VI-4 shows the rapid drop in nonfood commodity prices during most of 1974, a development clearly dominated more by the world slump in demand than by longer-run increases in supply in response to the high prices of the previous year. (Indeed, a danger of imitation of the OPEC cartel formula exists in a number of commodities.) Nevertheless, as a fall in food prices — definitely under way in early 1975—is added to the decline in other commodities (except oil), Israel, which suffered more than others from the rise in import prices, will benefit more than most countries because of the exceptional significance of the terms of trade to an economy whose import surplus constitutes a very large fraction of the total resources available for domestic use.

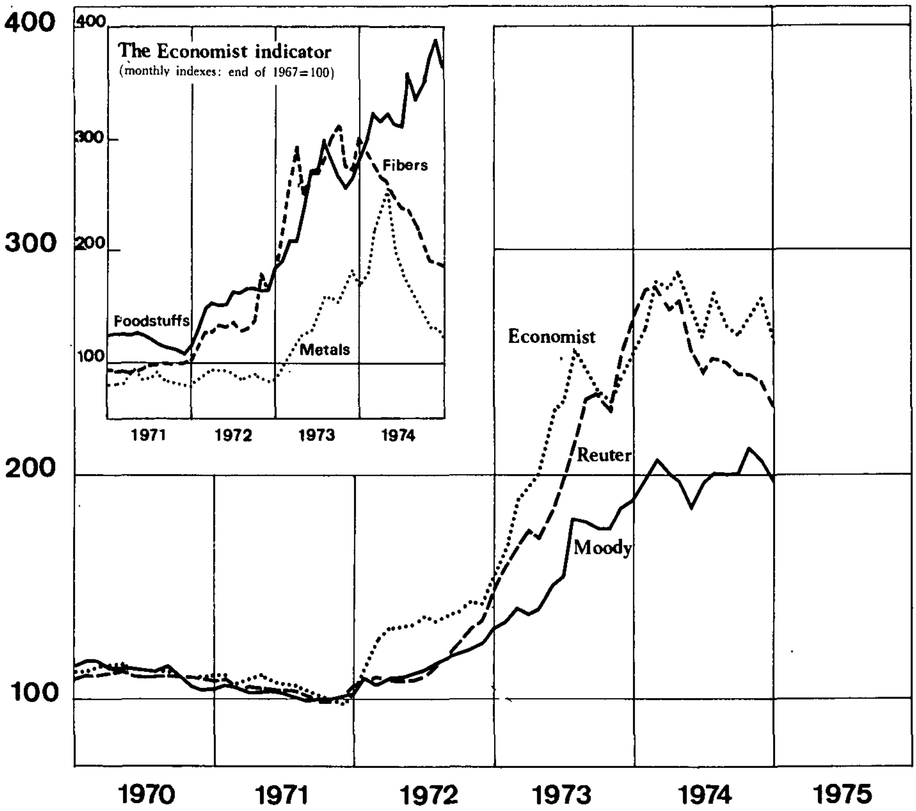
This, however, will only reverse part of the heavy burden imposed upon the Israeli economy in 1974 by the extraordinary average drop in its terms of trade. The burden reached its peak in the first quarter of the year (when the terms of trade were

the other sectors. The statement in the text is strictly true of the probable price trend which would be consistent with a steady full-employment growth rate.

Figure VI-4

WORLD MARKET COMMODITY PRICE INDEXES, 1970–75

(1967=100)



26 percent below their level in early 1973), and thereafter declined slowly, but it was very heavy for the year as a whole (see Table VI-7).

The terms of trade deterioration goes far to explain the rise in consumer prices and, essentially, all of that in total resource prices in Israel relative to those of the national product (i.e. the GNP deflator). It thus implies, and explains, a fall in real national (or personal) income relative to constant price national product. Specific terms of trade effects on real national income are calculated in Table VI-7. It shows that in 1974 this factor offset (for the first time) most of the growth in real output and converted a rise in per capita output into a fall in per capita real income.[15] Finally, it should be emphasized that the declining trend in commodity prices cannot offset the larger part of this loss, which was due to the OPEC oil price rise.

[15] In principle, the terms of trade effect on national income (in Table VI-7) should be

8. Developments on the Oil Front

As the year drew to a close a good deal was heard about the new "oil surplus". Unfortunately, most of this stems from the world recession, and not from conservation, substitution of other fuels, or increased output of oil outside the OPEC. Of course, efforts are under way in all these directions, but the slowness of the response is suggested by the fact that, despite greatly expanded drilling activity, oil production in the U.S. continued to fall perceptibly in 1974. In other words, so far the stimulus to additional investment has done no more than to slightly stem the rate at which output was otherwise likely to decrease.

No doubt within another year or two increases in output will start to "flow through the pipeline". New discoveries in various parts of the world have accelerated, but so far OPEC has actually been under greater strain from the expansion of output by some of its own members (especially Saudi Arabia), which were programmed for expansion by large-scale prior investment, than from outside factors.

In any event, the OPEC bonanza is not likely to diminish greatly for several more years unless the consuming nations develop a willingness to "punish" the cartel through effective economic sanctions (or unless they insist on punishing themselves more than OPEC by keeping their economies in a long-term state of depression).

Meanwhile, in 1974 the high oil prices predictably led to large current deficits among the consumers, balanced by an equal surplus and net capital export by OPEC (estimated at about $55-60 billion). Various (roughly consistent) estimates have been released concerning the channelling of this surplus; Table VI-8 presents the figures of the U.S. government, while Table VI-9 gives an analytic breakdown of changes in OECD trade balances, accompanied by interpretive comments.

As noted earlier, one surprise has been the failure of the U.S. to garner as much of the total reflow of petrodollars as the increase in its oil import bill (of course, there is no necessary connection between these two quantities), and the correspondingly larger reflows to the Eurocurrency banks and to the U.K. The exchange market

equal to the difference between GNP deflated by the GNP and by the total resource deflator. However, the two may diverge for various reasons, including the fact that the terms of trade effect is computed with fixed weights for imports and exports in GNP and total uses, while the national accounts price deflators reflect actual changes in these weights (including some reactions to the price changes themselves). In addition, trade in services is implicitly included in the deflators, but not in the terms of trade effects calculated in Table VI-7. Price indexes for services (less reliable than for goods) indicate a partially offsetting improvement in Israel's terms of trade in this sector. Nevertheless, the national income effect calculated in Table VI-7 for 1974 relative to 1973 (−3.8 percent) is close to the deflator discrepancy(−3.4 percent).

Table VI-9

COMPONENTS OF TRADE BALANCE CHANGES IN SEVEN MAJOR OECD COUNTRIES, 1974

($ billion)

	Changes from 1973 to 1974			
	Total	Quantity	Oil prices	Other terms of trade
Canada	-0.50	-3.25	0.75	2.00
U.S.A.	-6.75	9.25	-17.00	1.00
Japan	-2.25	7.75	-12.50	2.50
France	-6.25	0.50	-6.50	-0.25
W. Germany	6.25	10.00	-6.50	2.75
Italy	-5.25	3.75	-5.25	-3.75
U.K.	-5.75	0.25	-5.25	-0.75
Total OECD	-36.50	25.00	-63.00	1.50
Of which:				
1) With OPEC	-43.25	13.75	-61.00	4.00
2) With nonoil developing countries	5.25	8.25	-1.00	-2.00
3) With other non-OECD countries	1.50	3.00	-1.00	-0.50

NOTES: (1) The fall in the U.S. trade balance did not reflect a deterioration in price competitiveness; rather, the large oil deficit overrode a very substantial increase in real net exports. (2) W. Germany and Japan achieved even larger increases (relative to their size) in real net exports, while France, Italy, and the U.K. did relatively little in this way to offset the effect of the oil price increases on their trade balance. However, this performance reflects the more deflationary policies of the U.S., Germany, and Japan. For France and Italy it reflects the maintenance of nearly normal growth rates, and for the U.K. an exceptionally extreme combination of recession plus high inflation. (3) The total OECD rise in "Quantity" (i.e. constant price net exports), but not those of individual countries, which are mainly intra-OECD, does reflect a sizable increase in demand from OPEC, but the rise vis-a-vis other areas (2 + 3) appears to reflect the negative effects of the recession on imports.

SOURCE: OECD. *Economic Outlook*, December 1974, Table 19.

impacts of Eurocurrency transactions, however, is not yet entirely clear; [16] so it is not certain that this disposition of the OPEC surplus contributed to the downtrend of the dollar in late 1974.

[16] Since petroleum is generally paid for in dollars, deposit of the receipts in Eurodollar accounts would not put any pressure on the dollar in the exchange market, but conversion of the proceeds to other currencies for deposit or lending purposes would do so. The first transaction would take the form of an increase in the liquidity deficit in the U.S. balance of payments (increased liquid liabilities to the rest of the world), but it would not exert any negative market pressure on the dollar exchange rate. In effect, it would be a form of short-term capital import. Specifically, such deposits of oil exporters would create new

Table VI-10

WEIGHTED AVERAGE CHANGES IN VALUE OF $ AND IL FROM SMITHSONIAN PARITIES (DECEMBER 1971), 1974-75[a]

(percentages)

	IL[b]				
	Weighted by imports		Weighted by exports		Dollar[c]
1974					
January	0.3		-2.4		-2.7
February	-1.7		-4.5		-6.3
March	-3.9		-6.5		-10.2
April	-5.5		-8.0		-10.9
May	-6.8		-9.3		-9.5
June	-5.5		-8.1		-8.9
July	-5.6		-8.1		-7.5
August	-4.2		-6.8		-5.3
September	-3.3		-6.1		-6.2
October	-4.4		-6.9		-7.1
November[d]	-5.6	(-33.9)	-8.5	(-35.9)	-8.5
December	-6.9	(-34.8)	-9.9	(-36.9)	-9.9
1975					
January	-9.0	(-36.3)	-11.9	(-38.3)	-12.0
February	-10.5	(-37.4)	-12.9	(-39.1)	-14.7
March	-10.9	(-37.7)	-13.8	(-39.7)	-13.1

[a] These series represent the changes in the amount of foreign currency obtainable per IL or per $, rather than the change in the IL price of foreign currency (the conventional concept of the rate of exchange in Israel).

[b] Monthly average position.

[c] End-of-month position relative to the 11 leading foreign currencies. The calculation is based on Reuter's index. The "basket" $ value used is fairly arbitrary. A more complete one, including the Canadian dollar and developing country currencies, would show a more stable $ value.

[d] The effect of the November IL devaluation is shown by the figures in parentheses. This lowered the IL value by 30 percent (i.e. to 0.7 times its preceding value). The effect was to reduce the month-to-month changes to 0.7 times their size in the absence of devaluation (i.e. the month-to-month changes in the figures not in parentheses).

Falling interest and profit rates in the U.S. and high interest rates in London were probably most responsible for the developments described above. Despite some concern over the ability of the world banking system to absorb and redistribute the very large share of OPEC funds placed with them (due to an initial tendency to

"Eurodollar" time deposits on the basis of existing U.S. dollar demand deposits, but the latter would change from liabilities to U.S. residents (the oil importers) to liabilities to foreigners (the Eurodollar bank).

concentrate on short-term deposits in a small number of the largest banks, which strained the normal deposit-equity ratios of these institutions), the recycling process proceeded with relatively little disruption. Toward year's end the steep drop in short-term interest rates (plus the resistance of some overloaded banks) appears to have engendered a clear trend toward widening the range of depository institutions and lengthening the term of deposits and other financial investments.

In addition, efforts to establish official or international recycling systems bore some fruit in 1974 with the introduction, and then the enlargement, of an IMF oil facility and agreement on the early establishment of a special $25 billion "support arrangement" by OECD members.

In general then, assuming reasonably prudent balance of payments policies in these countries, the purely financial problems of recycling no longer loom as the really dangerous aspect of the oil crisis, as they were often viewed in early 1974. This places the distortion of relative prices, the massive and inordinate transfer of real income and wealth to the OPEC states (from the poorest as well as richest states), and the erosion of the basis for peaceful international specialization and trade in their true light as the crucial aspects of the problem.[17]

9. Value of the U.S. Dollar and IL

Table VI-10 and Figure VI-5 summarize the development of the average rate of exchange of the U.S. dollar and of the IL, which is linked to it. The difference between the movements of the two currencies is due to the use of U.S. and Israeli trade weights respectively. In addition, of course, the Israeli weighted average diverged sharply in November because of the devaluation of the IL relative to the dollar itself. This depressed the average value of the IL by 27 percent of its level at the time of the Smithsonian agreements (December 1971), from which the percent changes in Figure VI-5 are measured.

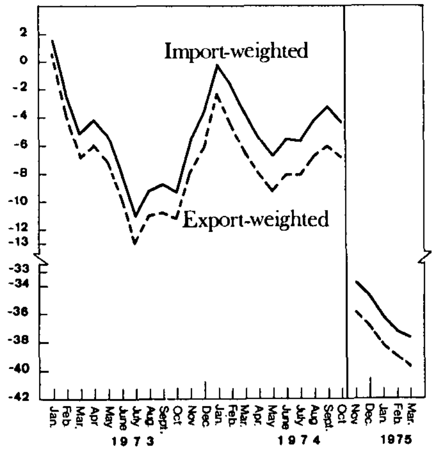
In 1974 the dollar (and with it the IL) first retreated from the peaks reached in the second half of 1973, then stabilized and climbed moderately until September, when the downward trend reasserted itself. (This persisted in early 1975 and shaved off an average of another 6 percent from the IL from the November devaluation to March.) On average, despite the extraordinary shocks of the oil crisis and the world recession, the fluctuations were more moderate than in 1973, the first year of the floating currency system. The most significant change, the renewed weakness of the

[17] One might add the encouragement of further cartel distortion and the massive short-term loss arising from the contribution of the oil price rise to the recession in the advanced countries. The latter was, however, more a result of policy adjustment in these countries than of the oil price rise itself.

Figure VI-5

AVERAGE VALUE OF IL IN FOREIGN CURRENCIES, 1973–75

(percent change from Smithsonian parities—December 1971)

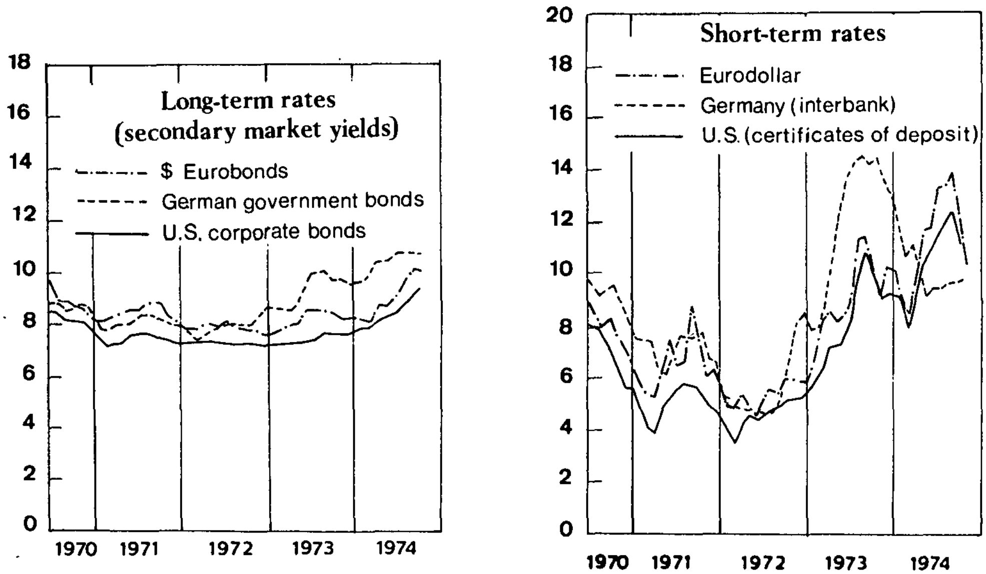


dollar since September, primarily reflects, as already noted, the steep slide of the U.S. economy, which has pushed down rates of return on equity investment and—with increasing momentum as credit demand subsided and monetary policy moved toward stimulus—interest rates as well. Statistical analysis shows that, at least since the 1960s, the negative impact of a relative slowdown in the U.S. economy (and the U.S. recession has been much more severe than that of Europe) on the capital account tends to outweigh its positive impact upon the trade and current accounts. Hence the dollar's weakness, which should be regarded as transitory and reversible with (or even in expectation of) a revival of the U.S. economy.

Figure VI-6

REPRESENTATIVE INTEREST RATES, 1970–74

(middle of quarter)



SOURCE: OECD, *Economic Outlook*, December 1974.

From February to May the higher rate of inflation in Israel was very partially offset by the downward float of the IL with the dollar; from May to September the reversal of direction of this float only exacerbated somewhat the further relative rise of Israeli prices. The renewal of the negative trend in September reinforced the effect of the discrete IL devaluation.

Nevertheless, for the IL (and for Israel's trade competitiveness and balance of payments in general) the fluctuations of the dollar in 1974 were insignificant in comparison with the much steeper rate of internal than external price inflation and the one-time adjustment of both the formal and effective rates in November.

The overall deficit and dwindling of reseves until November owed a great deal (as noted earlier) to devaluation expectations, which both inhibited capital imports and tended to accelerate real imports. These speculative effects were in direct conflict with the incentive to transfer funds to Israel arising from the widening of the differential between the nominal yield on index-linked bonds and interest rates abroad (about 45 vs. 10 percent for the year as a whole).[18] Thus, despite the "explosion" of the nominal yields on IL linked bonds, their direct purchase by foreigners dropped in 1974. The interest differential may also be taken as a reflection of the relative nominal yield on foreign investments in Israel generally, which, like linked bond sales to foreigners, exhibited a falling rather than a rising trend. Statistical analysis supports the conclusion that devaluation expectations did in fact outweigh the favorable interest differential.[19]

[18] Selected foreign interest rates are presented in Figure VI-6.

[19] It is noteworthy that, while sales of linked government securities to foreign residents were permitted before the devaluation — both in 1973, when devaluation expectations were much lower, and in 1974, when they were high enough to inhibit such sales — they have been prohibited since. This adds to the impressiveness of the postdevaluation change in the reserve trend.