

## CHAPTER III

### THE BALANCE OF PAYMENTS – A GENERAL SURVEY

#### 1. MAIN DEVELOPMENTS

1977 was the second consecutive year in which the balance of payments displayed rapid improvement. The deficit in the current account totalled \$2,560 million, as compared with \$3,320 million in 1976 and \$4,050 million in 1975; this constitutes a reduction of more than 40 percent at constant prices. The improvement for the entire term was almost equally subsumed under the two components of the deficit: the civilian current account and direct defense imports. Nevertheless, in 1977 the role of defense imports was decisive, displaying a decline of \$490 million, as compared with a decrease of \$220 million in the civilian deficit, excluding trade with the administered areas.

In each of the past two years there was a steep decline in defense imports which totalled \$750 million. At fixed prices, these imports dropped to less than half the 1975 level, reverting almost to that of 1971.

A substantial reduction of the civilian current account deficit also occurred. There was a 35 percent decline in fixed price terms as compared with 1975. This was due to the rapid growth of exports combined with the slower increase of imports. The rate of export expansion declined slightly (by 13.5 percent at fixed prices) in 1977 as opposed to 1976, whereas the growth of imports was slightly accelerated (by 5.5 percent). As a result the deficit was narrowed by 16 percent as opposed to 23 percent in the preceding year. During the year under study a structural change in the make-up of export growth ensued. The growth rate for export of goods declined in comparison to 1976 (11 percent against 23 percent), while the growth in export services jumped, with the bulk of the increase derived from tourism revenues. As in the previous years the sharp drop in investment asset imports was the principal contributor to the decline of import growth.

In the capital account a process typifying the previous year, which is the financial equivalent of the improvement in the current account, namely a reduced dependence upon inconvenient financing sources, continued. This was chiefly expressed in 1976 by an end to the increasing dependence on short-term financing sources – a pattern typical of the previous two years, and in 1977 by a substantial reduction in the need for long-term loans. The net increase in these loans was half of what it was in 1976, and one-third of the 1975 figure.

TABLE III-1  
CURRENT ACCOUNT<sup>a</sup>, 1971-1977  
(\$ million)

	Imports				Exports				Deficit					
	Goods	Services	Goods & services	Defense imports <sup>c</sup>	Total incl. defense imports	Goods	Services	Goods & services	Trade balance	Services	Total	Total incl. defense imports	C/a with admin. areas	Total current deficit
A. At current prices														
1971	1,768	765	2,533	536	3,069	900	905	1,805	-868	140	-728	-1,264	41	-1,223
1972	1,909	870	2,779	490	3,269	1,083	1,036	2,119	-826	116	-660	-1,150	36	-1,114
1973	2,894	1,170	4,064	1,253	5,317	1,368	1,289	2,657	-1,526	119	-1,407	-2,660	32	-2,628
1973 <sup>b</sup>	2,930	1,153	4,083	471	4,554	1,422	1,310	2,732	-1,508	157	-1,351	-1,822	28	-1,794
1974	4,073	1,605	5,678	1,224	6,902	1,706	1,733	3,439	-2,367	128	-2,239	-3,463	62	-3,401
1975	4,006	1,837	5,843	1,846	7,689	1,810	1,723	3,533	-2,195	-114	-2,309	-4,155	97	-4,058
1976	3,981	2,018	5,999	1,587	7,586	2,278	1,857	4,135	-1,703	-162	-1,864	-3,451	137	-3,314
1977	4,648	2,220	6,868	1,099	7,967	2,939	2,290	5,229	-1,709	70	-1,639	-2,738	181	-2,557
B. At 1972 prices														
1971	1,881	797	2,678	564	3,242	968	923	1,891	-913	126	-787	-1,351		
1972	1,909	870	2,779	490	3,269	1,083	1,036	2,119	-826	166	-660	-1,150		
1973	2,261	1,017	3,278	1,129	4,407	1,112	1,131	2,243	-1,149	114	-1,035	-2,164		
1973 <sup>b</sup>	2,405	1,042	3,447	437	3,884	1,174	1,211	2,385	-1,231	169	-1,062	-1,499		
1974	2,327	1,171	3,496	973	4,474	1,177	1,203	2,380	-1,150	32	-1,118	-2,096		
1975	2,189	1,250	3,439	1,347	4,786	1,191	1,180	2,371	-998	-70	-1,068	-2,415		
1976	2,224	1,302	3,526	1,112	4,638	1,470	1,206	2,676	-754	-96	-850	-1,962		
1977	2,396	1,291	3,687	723	4,410	1,633	1,396	3,029	-763	105	-658	-1,381		

C. Index of quantitative growth  
(1972 = 100)

1971	99	92	96	115	99	89	89	89	111	78	115	117
1972	100	100	100	100	100	100	100	100	100	100	100	100
1973	118	117	118	230	135	103	109	106	139	69	156	188
1973 <sup>b</sup>	126	120	124	98	117	108	117	113	149	102	161	130
1974	122	135	126	200	137	109	116	112	139	19	169	182
1975	115	144	124	275	146	110	114	112	121		162	210
1976	117	150	127	227	142	136	116	126	91		129	171
1977	126	148	133	148	135	151	135	143	92	63	100	121

D. Prices indexes  
(1972 = 100)

1971	94	96	95	95	95	93	98	95
1972	100	100	100	100	100	100	100	100
1973	128	115	124	111	121	123	114	118
1974	175	137	163	125	154	145	144	144
1975	183	147	170	137	161	152	146	149
1976	179	155	170	142	164	155	154	153
1977	194	172	186	152	181	180	164	173

a On the basis of import records CIF and export FOB including balance of payments adjustments.

b First three quarters at annual rates.

c From 1976, includes transport expenditures on foreign ships.

SOURCE: Central Bureau of Statistics.

Despite the appreciable reduction in the deficit, the balance of payments problem continues to be the central difficulty of the economy. Its superficial expression has changed with the change in economic conditions: at present it is not the actual deficit, but rather the lack of growth and extended economic stagnation. The reduction of the deficit is to a great extent a result of the standstill condition; on the other hand, it appears that the conditions needed to return the economy to the path of long-term rapid growth which characterized it until the balance of payments crisis in 1973 have not yet been guaranteed.

At the end of October there was a foreign currency reform which included far-reaching changes in the exchange rate regime and a liberalization of foreign currency exchange control. The impact of these changes, save for the short-term effects in the monetary field, were not yet perceptible in 1977, and it is still too early to observe their effects. Section 4 below will discuss some aspects of these changes.

## 2. THE CURRENT ACCOUNT

In 1977 the current account deficit totalled \$2.5 billion, as compared with a peak of \$4 billion in 1975. Quantitatively, 1977 brought a 30 percent decrease on the heels of a 19 percent decline in 1976; in contrast to 1976, the main reduction occurred in defense imports which more or less returned to their 1971 level<sup>1</sup>. The current civilian deficit displayed a real reduction of 23 percent for 1977, which follows a 20 percent reduction for 1976.

Import patterns of goods resembled in the main those of 1976: the level of input imports is almost entirely attributable to current production requirements whose growth rate is slow, and the continued accelerated decline of investment asset imports. The rise in the growth rate of imports, from 1.5 percent in 1976 to 7 percent can be ascribed mainly to fluctuations in imported inputs inventory: in 1974 and 1975 imported inputs were stockpiled while in 1976 the import volume returned to the level determined by current production requirements and stockpiling was discontinued. This was felt in a decline of input imports. In 1977, input imports were lower than in 1974, even though current production requirements rose by more than 7 percent.

The main cause for the past two year's slowdown in import growth was the decline in investment asset imports with the cumulative decline totalling 22 percent. By contrast, a substantial rise in diamond imports (5 percent in terms of value) was recorded, reflecting

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<sup>1</sup> This does not appear in Table III-1, where, starting with 1976, defense imports also include shipping expenses on foreign ships. In 1977 these expenditures reached 15 percent of the total. On FOB basis, defense imports are at the 1971 level in real terms.

large-scale stockpiling.

The same growth rate of total exports, 13 percent, obtained for the past two years but the component make-up of this growth underwent modification. The growth rate of service exports was accelerated (16 percent compared to 2 percent in 1976), while the growth rate of goods exports contracted considerably (from 23 percent to 11.5 percent). The large increase in service exports was derived entirely from tourism revenues (a growth of 55 percent in current dollars); it can be assumed that this figure possesses a considerable upward bias due to the impact of the currency market conditions on the tourists' predilection to change money on the black market.

The curtailed growth of product exports is entirely a result of the decline in defense and diamond exports. The growth rate for agricultural exports was similar to that of the previous year, albeit with a certain change in its two components: a slight resurgence in citrus, following a decline in 1976, and a slowdown in other agricultural exports. The growth of industrial exports, except for defense equipment, was similar in both years: 16 percent in 1976 and 15 percent in 1977.

Net diamond exports showed signs of a slowdown: growth slipped to 4 percent in 1977, as compared with 21 percent in 1976. The trend for the year was downward, as the fourth quarter was 20 percent lower than the first. The reliability of price indices in this branch presents a serious problem and makes evaluating developments very difficult. It would appear that recent developments reflect pressures on the diamond industry which is caught in a squeeze. On the one hand the price of raw diamonds has risen steeply due to speculative processes, which are in turn a result of the (mainly) temporary reduction of supplies. On the other hand it was impossible to pass these increases on to the final purchaser, especially in export markets, where economic activity has remained moderate.

The slow growth (3 percent) of citrus exports was characteristic of a long-term trend in the branch which principally reflects supply limitations. Simultaneously, there was a continued rapid rise (19 percent) in the other types of agricultural exports; these exports have grown much faster than any other type of export (excluding defense exports). The substantial increase in agricultural exports is the result of intensive research and development activities and an accumulation of knowledge, which have placed new products at the disposal of Israeli agriculture and have given it considerable competitive advantages. The development of suitable marketing bodies has also played an important role in this export field. Another factor is the subsidizing of capital investments: the dimensions of this subsidy grew considerably, due to the accelerated rate of inflation in recent years, and this may be one of the factors stimulating the growth of exports for those years when

TABLE  
CURRENT DEFICIT AND THE  
(\$ million,

	Current deficit	Of which: defense	Long-term capital			Total	Surplus or deficit (-) of long-term capital over the current deficit	
			Uni-lateral transfers	Long-term loans	Foreign investment			
1972	-1,114	-490	1,059	588	148	1,795	681	
1973	-2,630	-1,253	2,190	838	185	3,207	577	
1974	-3,397	-1,225	1,718	541	97	2,356	-1,041	
1975	-4,061	-1,846	1,770	1,476	68	3,314	-747	
1976	-3,316	-1,603	2,224	1,002	58	3,284	-32	
1977	-2,560	-1,099	2,005	503	90	2,598	38	
1975	I	-1,017	-513	523	295	29	847	-170
	II	-928	-377	441	372	10	823	-105
	III	-1,123	-494	426	337	21	784	-339
	IV	-993	-462	380	472	8	860	-133
1976	I	-739	-364	511	189	8	718	-31
	II	-919	-386	490	188	18	696	-223
	III	-776	-373	661	187	17	865	89
	IV	-882	-480	562	438	15	101	133
1977	I	-498	-222	433	164	122	610	621
	II	-745	-375	475	112	21	608	-137
	III	-730	-207	491	50	16	557	-173
	IV	-587	-295	606	177	31	814	227

NOTE: Increase in liabilities without a sign, rise in assets with (-).

\* Mainly short-term foreign asset items, such as commercial credit, loans of commercial banks to foreign residents, Bank of Israel loans, etc.

SOURCE: Central Bureau of Statistics.

## CAPITAL ACCOUNT, 1972 - 1977

at current prices)

Short-term capital								
IMF cred- it	Credit to non- financial sectors		Liquid foreign obligations of Israeli banks	Total short- term credit	Foreign currency reserves	Short- term capital	Other items*	Errors & omissions
	Private sector	Government sector						
-33	1	37	-93	-129	-502	-631	-55	37
	-6	23	211	228	-522	-294	-266	-17
39	35	59	462	556	776	1,332	-80	-250
215	230	-70	528	688	-68	620	-80	-7
89	153	78	103	334	-124	210	-240	-27
	9	8	-29	-12	-238	-250	129	82
94	83	14	297	394	-254	140	-227	162
16	37	-111	-62	-136	-8	-144	157	77
	45	11	2	58	182	240	94	7
105	65	16	291	372	12	384	-104	-253
	-25	25	-120	-120	59	-61	75	17
	140	16	37	193	-64	129	-61	155
75	-15	53	45	83	-72	11	100	-75
14	53	-16	141	178	-47	131	-154	-124
1	-57	15	-66	-108	-142	-250	-16	145
	71	20	7	58	-26	32	66	38
	-3	17	7	21	-6	15	78	80
	-2	-4	23	17	-64	-47	1	-181

an economic slowdown was regnant in export markets<sup>2</sup>.

The development of export should be viewed against the background of several inter-related causes: changes in the competitiveness of exports as a result of both exchange rate policy and changes in the level of expenditures; and patterns in both the foreign and domestic markets.

1977 was marked by a considerable deceleration in the expansion of the world market as compared with 1976, when the world economy lifted out of the recession. The rate at which the world market grew was also slower than the long-term trend of the past (though conditions were easier than in the two recession years of 1974 and 1975). The restraining effect of the slowdown in the growth of world demand was not apparent in the development of Israeli industrial exports, excluding defense equipment. This fact is presumably related to the increased positive influence of two other factors: the profitability of exporting and, primarily, the recessionary conditions of the domestic market.

The effect of the domestic demand restraint has been felt in the accumulation of unutilized production capacity, which reached significant dimensions<sup>3</sup>. Export's main competitor for domestic production capacity – domestic demand – was essentially ejected from the arena. In the past two years domestic demand shrank at a cumulative rate equivalent to 6 percent of the entire business sector product (see Table II-4), in a period when production capacity rose by 10 percent, and unutilized production capacity climbed

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<sup>2</sup> The substantial increase of capital subsidization, although it leads to larger exports, is not always a blessing. It greatly increases the gap between profitability for the individual and profitability for the economy, so that it is liable to lead to the development of exports which are an economic loss.

<sup>3</sup> It should nevertheless be pointed out that under-utilization mainly reflects under-employment of capital rather than of labor, and that in the short run the substitution between the two is limited. The under-employment of labor is only slightly reflected in overt unemployment, (cumulative growth of one percent). Other manifestations are hidden unemployment, whose magnitude in the industrial sector are relatively small, reduction in the rate of participation in the labor force, and a substantial slowdown in population growth.

A focal point in the question of under-utilization of labor and the role this factor plays in the processes at work in the economy in both the short and the long term is the absorption of the additions to the labor force by the public sector in recent years. In the short term this fact has seemingly prevented a potential expansion of exports under the given conditions of profitability, and in the long run it has prevented a greater improvement in profitability by means of putting a check to wage increases.

TABLE III-3  
INDICATORS OF EXPORT PROFITABILITY, 1966 TO 1977

	Wage per unit of output relative to value added "price" in export (1)	Industrial export return relative to cost level (2)	Industrial export return relative to domestic market return (3)	Domestic market return to industry relative to cost level (4)	GNP deflator in exports relative to GNP deflator in non-tradables (5)
1966	146.2	79.4	74.3	106.9	
1972	100	100	100	100	100
1973	92.5	104.3	106.5	97.9	89.6
1974	91.3	100.6	104.3	96.5	79.1
1975	84.0	104.9	111.1	94.4	83.6
1976	88.0	103.7	112.9	91.9	92.5
1977	88.8	106.7	121.7	87.7	99.9

NOTE: The source of columns (1), (2) and (3) is Table V-5; column (4) is column (2) divided by column (3). The source of column (5) is table V-2.

above 20 percent<sup>4</sup> (see Table II-7), after taking into account the rapid increase in export during these two years. The restraint of economic activity possessed further influence on export profitability: the halting of price increases relative to export prices (and costs) increased the relative profitability of exports over domestic marketing. This also dampened price rises in domestic inputs, thus contributing to a slowdown in rising costs, which in turn minimized the erosion of the contribution of devaluations to export profitability and permitted a larger cumulative real devaluation. The outstanding expression of the improvement in export profitability is the rise in industrial export prices relative to the return in domestic marketing, which reached 17 percent in comparison with 1974 (see Table III-3).

Another indicator showing the substantial improvement is the comparison of the change in value added prices in export to value added prices in nontradable goods. In the past two years there has been a significant increase in value added prices of tradables against value added prices in nontradables, though this increase only corrected the opposite change in the years 1973 and 1974 (mainly due to the serious deterioration of the terms of trade at that time).

But the picture of export profitability is not unambiguous. It must be remembered that the economy has been in a period of transition resulting from the need for structural changes, so that the significance of developments is different when examined from the short- or the long-term viewpoint. The rise in the relative prices of industrial exports in comparison to local marketing was achieved via a squeeze on the profit component, while wages were adjusting themselves completely to changes in the exchange rate. This type of change in relative prices is a typical characteristic of a restrained economy under conditions of cost push; the question is whether this sort of change will prove to be a stable one or is just a passing phenomenon<sup>5</sup>.

Another indicator, the ratio between wage expenditure per unit of output and export return, shows no significant improvement. Following a certain improvement in 1975, there was a deterioration in the past two years, and the level is not significantly different than in 1973.

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<sup>4</sup> 35 percent when the comparison is made with the actual product as presented here. The estimate of unutilized productive capacity assumes labor input in the business sector larger than it actually is and reflects an assumption on the potential growth of labor input corresponding to the growth of the working population. An estimate based on actual employment shows unutilized production capacity of 15 percent of total production capacity (compared to 20 percent above).

<sup>5</sup> See the more detailed discussion in Section 3 below.

Industrial exports had a decisive weight in the increased industrial output of recent years. Over the period of the past four years, direct exporting accounted for 45 percent of the increase in industrial output<sup>6</sup>. Naturally, the major part of the growth occurred in the past two years, when industrial exports rose at an average of 21.5 percent, as compared with a growth of 2.6 percent in local marketing. During this period direct exports sustained 57 percent of the increase in industrial output.

Nevertheless, it should be remembered that this development mainly reflects a halt in the growth of domestic demand (and primarily the sharp drop in investments), and not the absorption of production factors in the export sector at a faster rate than in past expansionary periods. The latter kind of absorption would have increased the export share of the economy's total productive capacity and not just the share of the actually utilized productive capacity (while most of the increase in productive capacity is "absorbed" by the product gap). The growth rate of exports did not outstrip previous expansionary periods (the four years 1968-1971), and export's share in the increase of potential output was no higher. It is true that in the past two years, 1976 and 1977, the share of exports in the increase of potential output rose quickly, in contrast to the two previous years, but this change took place against a background of sharp decline in the weight of exports in this sphere.

Developments in productive factor absorption within the export sector fit the previous depiction of export profitability trends. The index, based on the ratio of wage costs to the return on value added in export, does not reveal that conditions for an additional expansion in the demand for labor in the export sector have been created.

The similarity between the present period of export expansion and the previous one is not complete. The differences lie in the seriousness of the balance of payments problem as well as in the large-scale unemployment during the period of the recession which preceded the previous expansionary period, and in the significant increase in workers from the areas. The previous period was not actually a time of reduction in the current deficit<sup>7</sup>, so that it was exempt from the difficult task of cutting domestic absorption relative to the GNP.

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<sup>6</sup> Its total share was higher, since output includes, in addition to final sales, sales to intermediate destinations, some of which were used for production of export goods.

<sup>7</sup> In 1971 the current account civilian deficit was 50 percent higher than in 1965, just before the recession, at constant prices (GNP also grew at the same rate). The recession itself derived from a feeling of urgency in the need to reduce the deficit, but as things developed, the perspective changed regarding the ability to finance the deficit, and the feeling of urgency regarding its reduction disappeared.

Also from the perspective of relative price changes, the latter period faced a much more difficult challenge. The central factor in the balance of payments crisis was the serious deterioration of the terms of trade, which caused greater harm to export profitability than to production for the domestic market. This occurred because export industries possess a larger import component and because they are more exposed to competition in the world market. An improvement in the profitability of exports dictated by balance of payments objectives should therefore have ensured not only a change in relative prices compared to the pre-crisis situation, but it should also have promoted a correction of the relative deterioration in export profitability resulting from the crisis. Additionally, given the formal and informal linking arrangements within the economy, the relative rise in import prices was translated into relative increases in wages and domestic input prices as well.

The third difference concerns world market conditions. The slowdown in world economic activity following the oil crisis undoubtedly placed a heavy burden on export expansion (though this mainly relates to 1974 and 1975; the growth in world demand in the past two years did not average less than in previous expansionary periods).

There exist other notable differences between the two periods: the previous expansionary period came after a year of wide-scale unemployment which was undoubtedly felt in the wage changes of the following years. Another difference: the absorption of production factors in the export sector in the previous period took place in an economy undergoing rapid growth, with full utilization of the production factors at its disposal. During the present period, production factors have been absorbed by the export sector to a similar extent, but within a totally different economic environment: the economy is at a standstill, and all competition from domestic demands has been eliminated.

The gravity of the problem created by the 1973 balance of payments crisis was clearly more severe than that of the previous period, and the gravity of the tasks that confronted the economic policy was proportionately more onerous. Nevertheless, even from the perspective of the more distant past, it can be stated that progress towards balance of payments goals was not a direct function of objective limitations (such as the growth of world demand, the existence of a ceiling on export expansion possibilities, etc.), but rather mirrors the degree of economic policy effectiveness. It is important to realize the huge objective difficulties which confronted the economic policy in its efforts to achieve an adequate degree of effectiveness towards the solution of the balance of payments problem. But it is also important to realize the degree of effectiveness actually achieved.

Two recent developments should be mentioned: the noticeably different trends in two broad groups of industrial branches, and the large share of defense exports in the increase

of export activity<sup>8</sup>.

The first group includes branches which from a technological standpoint lie in the more traditional realm<sup>9</sup>. What distinguishes this group is the very slow growth of exports, notwithstanding an almost total halt in the growth of domestic demand (see Table III-5) and the creation of a wide-scale, unutilized excess productive capacity. The average annual growth in the exports of these branches over the past four years is 5.4 percent. In some of these branches exports had not yet returned to the level of 1972 or 1973, and in others the level is only a few percentage points higher<sup>10</sup>.

The second group is composed of branches which belong mainly to the area of more advanced technology. In the first group, competition from countries at lower levels of development bulks large, while in the second group, greater competition emanates from developed countries. The rapid growth of exports in this group has continued for the past four years<sup>11</sup>, reaching an average of 33 percent per year.

The difference between the two groups was already apparent in the past, but it was far less blatant. Apparently this development reflects basic changes in the composition of world trade which promotes changes in the structure of the relative advantage of the Israeli economy. This kind of change makes an economic restructuring incumbent (as opposed to the change required by the balance of payments crisis). Every structural change requires a transition period, and there is no doubt that the changing trends of world trade increase the difficulty of implementing the structural change required by the balance of payments.

In this context there is a phenomenon belonging to the realm of environmental conditions whose task it is to abet the processes in adjusting to external changes. Even in those industries destined for relative reduction, where there was a substantial deceleration in the growth of output and exports, the rapid investment process continued until a late

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<sup>8</sup> Although there was a certain lull at the end of 1976 and the beginning of 1977, this trend revived at the end of 1977.

<sup>9</sup> These are the branches whose share in the output of industrialized countries is in relative decline, while the share of the developing countries in their output is growing.

<sup>10</sup> In Table III-5 this group includes two branches whose connection to it is doubtful – food and miscellaneous – and they raise the average considerably.

<sup>11</sup> The data in Table III-5 on this point have an upward bias, since the basis for comparison is all of 1973, when the average level was influenced by the large drop in the fourth quarter.

stage of the slowdown, and a wide-scale accumulation of unutilized capacity ensued<sup>12</sup>. This development was apparently due to two factors: first, public credit for investments was rendered very cheap and huge inflationary capital gains accrued from it by the accelerated rate of inflation. Second, the entrepreneurs did not possess a clear picture of relative profitability (owing to the fact that a real devaluation was never implemented) and the feeling that the economic stagnation was a passing temporary phenomenon which would not leave many changes in its wake. This attitude, which did not of course grow in a vacuum, was apparently quite common and continued for an extended period (if not to the present). Undoubtedly this sort of attitude led to unsound investments and constituted an obstacle to structural change.

Rapid growth distinguishes defense exports from other industrial exports (see Table III-6). These exports, deriving from a relatively small sector of industry, contributed considerably to the increased output of recent years. These differences in growth rates have great significance for economic policy. Defense exports are affected by special non-economic supply and demand factors. The weight of these factors is unknown, and though economic factors must have their own effect, there is no way to estimate their true contribution.

In order to estimate the contribution of the factors controlled by economic policy, it is worth focusing on industrial developments excluding defense exports. Here the growth in export is much slower (an average of 9 percent in the past four years, contrasted to 15 percent in the total including defense exports). Even if the rapid expansion of defense exports (whose continuation is difficult to forecast) reduces the need for contributions from the other economic sectors, the need for substantial contributions from them remains. In regard to export expansion of industry as a whole except defense, there was initially no reason to set such limited goals. The real 15 to 16 percent annual growth of the past two years should be weighed against the rate of growth achieved in the past by the economy under conditions of rapid expansion; the slow cumulative growth of exports in the previous years (1972 to 1975); and especially against a background of the eliminated competition from domestic demand and the existence of such large-scale unutilized productive capacity.

### 3. THE CAPITAL ACCOUNT

The principal feature of the capital account in 1977 was a reduced dependence upon financing sources at poor terms, in tandem with the decline in the current deficit. This to some extent represents a continuation of 1976 developments. The reduction of the deficit in 1976 to the magnitude of long-term capital imports was reflected in a halt to the growing dependence on the short-term finance characteristic of the previous two years. In 1977

<sup>12</sup> See Appendix, Table VI-2.

the reduction in the deficit was reflected mainly in a diminishing need for long-term loans, whose net growth was much less than that of previous years. The level of short-term source utilization declined slightly from the level attained in 1975. There were some changes in the composition of sources and uses of short-term capital.

The proportion of American aid in long-term capital declined slightly: from 55 percent to 52 percent. This drop reflects the \$500 million reduction in defense imports, and is relatively small in relation to this latter magnitude.

Concomitant to the reduction in the deficit, there was also a decline in all types of capital importation. To a great extent, this reflects the primary source of the deficit reduction: the decline of defense imports. The decline occurred mainly among compensatory financing items, connected with deficit financing requirements, while other types of capital imports showed an increase.

There was a \$200 million decline in unilateral transfers, which was entirely a reflection of the reduction of transfers to the public sector (American aid by \$200 million and Jewish Agency transfers by \$100 million). Net transfers to the private sector rose by \$60 million. This represents a certain change in the trend of recent years (though it should be remembered that this nominal increase of 10 percent is in the same range as the inflationary reduction of the dollar's value): the continuous decline in net transfers since 1972 ceased in 1977, and net transfers stabilized at a low level, about 50 percent of the 1972 level in real terms.

A similar reversal took place in foreign investments, which doubled in the first three quarters of 1977 and rose by 60 percent during the entire year: here too the growth took place against the sharp decline of previous years; the foreign investment level in real terms this year was about one-third of the 1973 level.

The decline in the deficit found its chief expression via a decrease in long- and medium-term borrowing. This totalled \$500 million net, while in 1976 it reached \$1.0 billion, and in 1975, \$1.5 billion<sup>13</sup>. The decline was mainly in the item "other loans", which is the less preferred source for long-term capital, and it totalled \$300 million. The loans from the United States government also dropped by \$300 million, paralleling the decline in defense imports.

There was a decline in the dependence on short-term sources compared with the two previous years (\$150 or \$300 million, depending on the definition used); but there were changes in the composition of the short-term sources and uses.

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<sup>13</sup>\$1.1 and \$1.7 billion, if credit from the International Monetary Fund is included.

The overall level of short-term credit from abroad did not change, after rising by \$300 million the previous year. If we add the credit to domestic bodies whose source is not increased liquid liabilities abroad, but rather liquidation of assets there, the result is a \$170 million increase, compared with an increase of \$400 million last year. Against this rise in net liabilities, there was a \$200 million rise in liquid assets of the central monetary authorities compared to \$300 million last year. It follows that utilization of short-term credits fell by \$50 million in 1977 after rising by \$100 million in 1976. Within the liabilities of the banks, mention should be made of the \$200 million decline in net liabilities to foreign banks against a rise of \$330 million in deposits of foreign residents. In their dealings with foreign banks, the Israeli banks shifted from a position of net borrowers of \$300 million to that of net lenders of marginal amounts.

#### 4. THE BALANCE OF PAYMENTS PROBLEM

Despite the reduction of the deficit, the balance of payments remains the central problem of the economy. The outward manifestations have changed with the drastic turnabout in the economic climate since the balance of payments crisis of the end of 1973. By now it is not a large current deficit, greatly exceeding long-term financing ability, but rather the stagnation and the prolonged economic standstill from which the economy has not been able to escape. According to a slightly different formulation: the problem is not the actual, but rather the potential deficit which is likely to materialize with the resumption of growth. It is this potential deficit which is preventing a return to the rapid growth which characterized the economy before 1973.

Solving the balance of payments problem has been the focus of economic policy efforts in recent years. Such a solution requires changes on two levels: changing relative prices in favor of exports in order to encourage the expansion of the export sector by increasing its profitability; and changing the allocation of resources, in order to release resources for export needs. These changes are part of a single system geared to promoting a structural change in the economy (which is to be expressed in the relative expansion of the export sector and a relative reduction of domestic uses).

In these areas there have been multifaceted changes in recent years. The overall picture is complex and at first glance appears far from unambiguous. It should not be forgotten that these changes took place not in a stable economic environment, but amidst drastic changes in the economic climate. This background constitutes part of the data which must be reckoned with in evaluating the processes which have taken place, and in analyzing them from the standpoint of the needed structural change and the necessary conditions for its emergence.

Exports' share in total output has undergone a substantial increase recently. Since 1973 exports have jumped by 38 percent, compared to a 10 percent growth in the GNP and 12 percent in uses. This was reflected in a rise in the weight of export in uses from 23 to 28 percent; exports' share in incremental uses was 72 percent. Industrial exports displayed similar patterns: the weight of direct exports in industrial output rose from 13.6 to 19 percent, and its weight in incremental output reached 45 percent. These developments appear impressive but they must not be viewed in isolation from the general background of a mired economy. A different picture emerges when the comparison measures increases in potential output.

In the area of relative prices it is possible to use different measures, and get a different picture. The measure which is apparently of the widest applicability – value added prices in the tradable goods sector relative to those of the nontradable sector – is also the most problematical from the point of view of reliability and rests on the greatest number of assumptions<sup>14</sup>. According to this measure there have recently been sharp fluctuations. In 1973 and 1974 there was a decided worsening in tradables, due chiefly to deteriorating terms of trade which reflected the large rise in import prices and especially those of input imports. Since 1975 there has been a reversal, and the relative price of the product in the tradable sector has returned to its level prior to the balance of payments crisis. This change was the result of conditions created by economic policy: devaluations which caused a rise in export prices, and restraint of domestic demands, which did not permit a full adjustment of domestic prices to the increased prices of inputs. Two questions still remain: the first is to what extent was the correction of the relative price of tradable goods sufficient, or does the needed structural change require not only a return to the level before the crisis, but a shift to an even higher level; and the second, to what extent is the change which was achieved permanent, or is it just temporary, reflecting a squeeze of the profit component in an economy subject to restraint conditions.

A somewhat similar picture is obtained from a comparison of returns on industrial exports to the level of costs. Since 1973 there has been a slight rise, with fluctuations, of no real significance (see Table III-3, column 2). This is in sharp contrast to the developments between 1966 and 1973. In contrast, a comparison of return to industrial exports with that in domestic marketing (Table III-3, column 3) shows a substantial rise in the relative profitability of exporting between 1973 and 1977.

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<sup>14</sup> And this is excluding the conceptual problems, concerning its significance under conditions in which the export price is not given from the point of view of the economy. A price rise under these circumstances is liable to reflect cost pressure and a blow to the competitiveness of export, rather than an improvement in its competitive position.

TABLE III-4  
 CHANGES IN RESOURCE ALLOCATION IN THE ECONOMY, 1972-1977  
 (In IL billions, 1975 prices)

	1972	1973	1976	1977	Growth rates		Weight in uses 1972	Weight in increase in uses 1972-1976
					1973- 1977	1972- 1977		
GNP	66.6	69.3	76.5	77.2	15.9	11.4		
Imports, excluding ships, aircraft and defense	34.6	39.5	44.3	46.5	34.4	17.7		
Total	101.2	108.8	120.8	123.7	22.2	13.7		
Private consumption	39.6	43.0	48.8	50.5	27.5	17.4	39.0	49.3
Public consumption, excluding defense	15.6	18.6	20.3	20.0	28.2	7.5	15.4	19.9
Total	55.2	61.6	69.1	70.5	27.7	14.4	54.3	69.2
Investment, excluding ships and aircraft	22.6	22.6	21.5	19.0	-15.9	-15.9	22.2	-16.3
Total	77.8	84.2	90.6	89.5	15.0	6.3	76.6	52.9
Exports	23.8	24.7	30.3	34.2	43.7	38.5	23.4	47.1
Business product					11.7	7.6		
Product of the public sector and nonprofit institutions					31.6	9.9		

The apparent contradiction between these two measures derives from the fact that the combination of these two phenomena means a rise in the level of costs relative to the returns in domestic marketing (Table III-3, column 4). This phenomenon is typical of an economy under restraint conditions combined with cost inflation, when the inability of producers to raise prices at the same rate as costs causes a squeeze on profits. This relative decline of domestic prices which derives from a squeeze on profits is also reflected in the prices of domestic inputs (included in the measure of costs of column 2), and drags down the general level of costs. Thus this measure also reflects the economic standstill's influence on prices through the profit component. This same phenomenon of a squeeze on profits in a restrained economy is also reflected in a relative change in product price in the tradables sector (Table III-3, column 5). This development is problematical from the balance of payments standpoint since it relies for its very existence on a prolongation of the economic stagnation, a condition which cannot constitute part of a real solution to the balance of payments problem — a solution that must provide for the resumption of growth.

Another indication of trends of profitability is the ratio between wage costs per output unit and the returns on export<sup>15</sup> (resulting from exchange rate changes and changes in prices abroad); and when the exchange rate or the price rise abroad is different for exports and the import component — the ratio between wage costs and the returns to value added per unit in export. This measure (Table III-3, column 1) shows no significant change in comparison to 1973. Additionally the assumption that the measure in Table III-3 possesses a downward bias has some basis<sup>16</sup>.

The importance of this measure is that it defines a requisite condition for structural change. Every shift in the direction of expanding the export sector and increasing its demand for labor requires a rise in the exchange rate relative to wage costs. Under present conditions, the superiority of this measure stems from the sensitivity of the profit component to changes in conditions of economic activity and to the different influences exerted on it in various sectors. An alteration in relative prices in favor of exports, by means of a squeeze on the profit component in the domestic market, is an alteration whose existence depends on a continuing condition of restraint. A lasting change that would pave the way for a structural change in the economy cannot depend on a squeeze

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<sup>15</sup> This is essentially a measure of the changes in real wages from the point of view of the producer: the price of a production factor, labor, in terms of the product for which it is a production input. Under given conditions (productivity and capital stock), these changes are the ones which explain the changes in the demand of the export sector for labor.

<sup>16</sup> An alternative measure that also takes into account one-time wage payments shows a level that is 6 percent higher for 1976.

TABLE III-5

## INDUSTRIAL EXPORTS AND OUTPUT, 1967-1977

	1967-1971	1973-1977	1973-1977*
	(Annual average growth)		
<b>"Progressive" branches</b>			
Output	34.3	7.4	
Domestic marketing	23.2	3.7	
Export	30.5	32.8	
<b>"Traditional" branches</b>			
Output	13.8	2.9	
Domestic marketing	12.7	2.4	
Export	19.5	5.4	
<b>Total industry</b>			
Output	16.7	4.9	(3.8)
Domestic marketing	16.0	3.2	(2.0)
Export	21.1	14.1	13.3
Growth in foreign markets	9.6	2.8	
	(Cumulative growth)		
Weight of export in output increase	17.6	44.8	
Weight of export in potential output increase	17.6	16.9	

\* Comparison with the average for 1973 is liable to be biased, since this average reflects the sharp drop in the fourth quarter. This column contains a comparison with the level of the period before the shock of the war and the balance of payments crisis.

TABLE III-6

## INDUSTRIAL EXPORT GROWTH BY GROUP, 1973-1977

	Growth rates 1973-1977	
	Cumulative growth	Annual average
Total industrial export (excluding diamonds, minerals and oil)	75.9	15.2
Total industrial exports, excluding defense exports	42.0	9.2
“Traditional” branches	23.4	5.4
“Progressive” branches, excluding defense	97.8	18.6
Defense exports	376.6	47.7

in the profit component alone while wages maintain a constant ratio to the exchange rate.

A solution to the balance of payments problem also requires change in the allocation of resources in the economy. A reduction in the import surplus means a cut in domestic uses relative to the GNP. There has in fact been a substantial decline in the civilian import surplus in comparison with 1973 and 1974<sup>17</sup> (35 percent in quantitative terms). This is reflected in the rise in the share of exports in the GNP and a parallel drop in domestic uses. The civilian domestic uses surplus on the GNP fell from 21.5 percent in 1974 to 16 percent in 1977. But this reduction does not tell the full story. A central element here is the drastic change in the composition of uses, reflecting the sharp and long-term change in the economic climate. The entire reduction was born by investments, while both public and private consumption increased their share of the GNP. Between 1973 and 1977 consumption increased their share of the GNP. Between 1973 and 1977 consumption grew by 14 percent while investment fell by 16 percent (see Table III-4). Within the given framework of resource constraint, a reduction in import surplus was essentially made

<sup>17</sup> Here civilian means excluding direct defense imports.

TABLE III-7

## ISRAEL'S TERMS OF TRADE FOR GOODS, 1969 - 1977

	Import price index	Export price index	Terms of trade	Import price index excluding diamonds	Export price index excluding diamonds	Terms of trade excluding diamonds
(1968 = 100)						
1969	105.0	104.7	99.7	104.4	103.7	99.3
1970	105.6	104.4	98.9	106.7	103.5	97.0
1971	109.2	108.4	99.3	111.9	105.6	94.4
1972	115.8	116.2	100.4	118.0	109.9	93.1
1973	148.1	142.9	96.5	151.3	131.5	86.9
1974	202.9	169.1	83.3	202.3	167.5	78.9
1975	215.1	177.6	82.6	225.0	182.6	81.2
1976	212.7	180.8	85.0	221.6	180.0	81.2
1977	231.9	214.4	92.5	239.4	193.4	80.8
(1974 = 100)						
1975	I 110	107	97.3	111	111	100.0
	II 110	105	95.5	110	112	101.8
	III 104	103	99.0	104	107	102.9
	IV 101	103	102.0	101	106	105
1976	I 102.3	107.7	105.3	101.8	106.8	104.9
	II 104.2	103.5	99.3	103.4	104.6	101.2
	III 105.0	105.2	100.2	104.8	103.1	98.4
	IV 108.0	111.1	102.9	107.7	111.4	103.4
1977	I 110.1	114.5	104.0	110.1	111.7	101.5
	II 113.1	124.8	110.3	112.0	113.6	101.4
	III 115.3	130.2	112.9	113.8	117.3	103.1
	IV 118.3	137.4	116.1	115.6	119.0	102.9

SOURCE: Central Bureau of Statistics.

possible by a drastic cut in investments<sup>18</sup>. The reduction of the balance of payments deficit was thus achieved by creating a large investment "deficit".

The nature of the change in resource allocation which accompanied the reduction of the import surplus has especial significance for the balance of payments problem. It implies that a return to the path of growth while employing the existing unutilized capacity will be accompanied by a steep rise in the weight of investment in uses<sup>19</sup>. A policy which eschews steering the economy on a path of slower long-term growth will have to provide a large share of the increment in resources which will materialize through the return to the path of growth to investment. A large portion of the unutilized potential has thus already been mortgaged in order to eliminate the investment "deficit". Under these conditions the resources available to increase consumption will be limited relative to the growth in GNP, and a return to the path of growth which characterized the economy in the past will require drastic means of income absorption policy. A reduction in consumption relative to GNP, which was not implemented in the four years of recession (as part of the reduction in the import surplus), must still occur in the future. This sort of re-allocation is one of the hardest things to achieve, and up to the present, the failure to do so is a serious stumbling block towards returning the economy to the path of growth.

In the field of investments the picture is complex, and its significance changes as one changes viewpoints. This is the area in which there was a steep decline, and it accounted for the entire reduction in domestic uses relative to GNP. This was reflected in a substantial reduction of the growth of capital stock. Over the long term, this means a drop in the potential for economic growth. On the other hand, for the short term, due to the economic standstill, the slower growth of capital stock<sup>20</sup> still greatly exceeded the needs of current production, and over the past four years wide-scale unutilized capital stock has accumu-

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<sup>18</sup> In a rough way it is also possible to present things as follows: between 1972 and 1977 investment dropped from IL 22.6 to IL 19.0 billion (in 1975 prices, see Table III-4), though to maintain the same relative share of GNP it should have grown to IL 26.2 billion. This IL 7.2 billion difference (between actual investment and the amount of investment needed to maintain its relative weight) was the contribution of the investment cut to the reduction in the import surplus. During the same period exports grew by IL 10.4 billion, but only about half of this amount is a contribution to the import surplus reduction (due to the import component in exports).

<sup>19</sup> Though naturally with a certain lag and not necessarily in the early stages of the recovery.

<sup>20</sup> In 1977 reaching half the average growth rate in the past.

lated<sup>21</sup>. The existence of this capital stock is crucial to the possibility of resumed growth. It reduces the need for additional investments as a condition for renewed growth, and thus also reduces the magnitude of required resource re-allocation. This should facilitate the resumption of growth. Furthermore, it could permit a limited range growth without additional investments.

On the face of it this situation seems to present another option to the economy: resumption of growth on the basis of the existing allocation of resources without restoring the share of investments in domestic uses to its level in the period of rapid growth before 1973. Such growth, which would accept the sharp decline in the weight of investment in the economy in recent years, might allow several years of growth at rates similar to those in the past,<sup>22</sup> but on the whole this would mean diverting the economy from the previous path of rapid growth to a path of long term growth, averaging perhaps 3–4 percent annually.

The economic processes and their relation to the required structural change can be examined from other angles as well. The growth of industrial exports, which attained a high rate in the past two years, plays an important role. Compared with the level just before the recession, the average annual growth of industrial exports reached 13 percent, compared with a 4 percent growth in output (see Tabel III–5). The significance of such rates of change, as pointed out above<sup>23</sup>, lies in a substantial change in the weight of exports in output, and especially in the increase of output. But this comparison must also be viewed against the background of a changing economic climate. In recent years export growth has taken place in an economy where the growth of domestic demand has halted and the growth of the product has come almost to a standstill. A large-scale unutilized capacity has been accumulated<sup>24</sup>, and the “product gap” in industry reached 30 to 35

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<sup>21</sup> But it should not be forgotten that the investments which lead to the creation of this capital stock were made in an unhealthy economic environment, with far-reaching subsidization of capital, and under condition of inadequate relative prices which economic policy was trying hard to change. It is therefore possible that some of these were unsound investments which only serve to distort the statistics.

<sup>22</sup> All this assuming of course that such a transition will not be accompanied by negative developments in relative prices. This is a questionable assumption to judge by developments of recent years.

<sup>23</sup> See Section 1.

<sup>24</sup> See Appendix, Table 1.

percent (this is without taking into account the possibility of a structural change which should have increased the share of industry in total productive capacity). Under these conditions, a comparison of the increase in industrial exports with the increase in actual output misses the point. The germane comparison is between the increase in exports and the increase in potential output. Such a comparison reveals no significant change from the previous period of export expansion (see Table III-5): in both periods exports took a similar share of the increase in potential output. It is the lack of change which indicates the profound difference between the two periods.

Recently, export has achieved its share of the increase in potential output after its main rival, domestic demand, was essentially expelled from the arena. The fact that despite such a substantial change in the surrounding conditions exports did not expand at the expense of other sectors but only maintained their share of total productive capacity attests to the conclusion derived from developments in relative prices. It appears that during this period there was no significant change in the profitability of export in those aspects pertinent to structural change.

It would appear that developments so far do not reflect a real structural change, but rather the conditions of an economy under restraint, in which one sector was hit more seriously, while another – export – due to the profit conditions under which it operates, cannot seize the opportunity to significantly increase its share of the total productive capacity of the economy. The sectors which did increase their share significantly were the unemployment sector (with regard to capital) and the public sector (in employment).

Recent years have in fact been years of substantial changes in the balance of payments and in relative prices: a large reduction of the deficit, rapid growth of export, a rise in the weight of export in output, an increase in the relative profitability of exporting compared to domestic marketing. But these changes are mainly the result of a continuing economic standstill. In regard to the required structural change and the prerequisites for its generation, real progress has apparently been limited. In the realm of both relative prices and resource allocation, the changes which have taken place have been neither stable nor long-lasting. The change in relative prices is largely a reflection of the squeeze on profits in domestic marketing as a result of a combination of restraint conditions and cost inflation (together with an absence of significant change in the ratio between wage costs and the exchange rate).

The change in resource allocation and the deficit reduction were achieved entirely at the expense of investment, while a reverse change occurred in consumption. In both these spheres developments are primarily a reflection of short-term influences and pursuantly the maintenance of these changes is contingent upon maintaining restraints. Although the

TABLE

**FOREIGN EXCHANGE RESERVES AND NET LIQUID FOREIGN**  
(\$)

	At Bank of Israel	At Treasury	Total reserves of monetary authorities (1)+(2)= (3)	Deposits of banks in foreign banks (4)
	(1)	(2)	(3)	(4)
1970	459	24	483	369
1971	732	36	758	677
1972	1,230	57	1,297	1,139
1973	1,810	169	1,979	1,328
1974	1,200	58	1,258	1,246
1975	1,184	105	1,289	1,225
1976	1,373	90	1,463	1,368
1977	1,571	199	1,770	1,995
1975 I	1,489	48	1,537	528
II	1,481	60	1,541	839
III	1,237	49	1,286	939
IV	1,184	105	1,289	1,225
1976 I	1,150	94	1,244	1,089
II	1,214	94	1,308	1,129
III	1,316	86	1,402	1,167
IV	1,373	90	1,463	1,368
1977 I	1,433	166	1,599	1,222
II	1,437	201	1,638	1,374
III	1,457	199	1,656	1,416
IV	1,571	199	1,770	1,995

NOTE: The reserve differentials here differ from the sums appearing in Table III-2. The difference is due to the fact that the reserves are also influenced by revaluation of currencies which are not included in Table III-2.

SOURCE: Central Bureau of Statistics.

**LIABILITIES OF ISRAELI COMMERCIAL BANKS, 1970-1977**  
million)

Deposits of foreign residents (5)	Deposits and loans of foreign banks (6)	Liquid foreign obligations of banks (5)+(6)= (7)	Net liquid foreign obligations of banks (7)-(4)= (8)	Credit to foreigners
317	97	414	45	
528	458	986	309	
673	670	1,343	209	
904	838	1,742	414	359
1,062	1,102	2,164	918	459
1,142	1,546	2,688	1,463	647
1,365	1,572	2,937	1,569	601
1,650	1,938	3,588	1,593	474
1,068	1,007	2,075	1,547	492
1,051	978	2,029	1,190	467
1,050	1,037	2,087	1,150	495
1,142	1,546	2,688	1,463	647
1,177	1,234	2,411	1,322	513
1,268	1,224	2,492	1,363	466
1,245	1,343	2,588	1,421	537
1,365	1,572	2,937	1,569	601
1,356	1,384	2,740	1,518	549
1,427	1,480	2,907	1,533	522
1,474	1,489	2,963	1,547	437
1,650	1,938	3,588	1,593	474

continuation of economic restraint for a limited period is a necessary condition for accomplishing the needed changes, it is not a substitute for them. It is a prerequisite for progress toward a solution, but it is not part of the solution. The changes involved are not long-lasting ones, representing a basis for structural change. From the point of view of long-term balance of payments objectives, they are mainly transitory, and do not permit a return to the path of rapid growth that characterized the economy until 1973.

## 5. THE FOREIGN CURRENCY REFORM

In October 1977 an economic reform was put into effect which included far-reaching changes in three areas: liberalization of foreign exchange control, a change in the exchange rate regime, and a transition from the creeping devaluation system to a floating exchange rate. The rates for all foreign currency dealings were unified, eliminating special support arrangement and reducing tariffs.

In the area of liberalization, the changes in the service accounts stand out, especially with respect to tourism (a far-reaching liberalization had already taken place in foreign trade). In the transfer account, there was an expansion in the possibilities of transferring foreign currency by Israelis abroad. And, of especial importance to the capital account, the remaining restrictions on dealings by foreign residents (most of the restrictions were cancelled in the liberalization measures effected in 1968) were lifted as were restrictions on foreign borrowing by Israelis. Permission to hold foreign securities and foreign exchange in Israeli banks was granted without limitation. Israeli bodies operating abroad are permitted to maintain bank accounts abroad for business purposes. Restrictions on the acquisition for assets abroad by Israelis remain in force.

The effects of the reform cannot yet be observed in the economy (except for short-term monetary effects). The discussion here deals with several aspects of the reform, mainly with the effect of exchange rate changes for current transactions on different sectors in the economy, and the effects of the changed exchange rate regime on the instruments of economic policy.

The floating exchange rate is from most aspects a more efficient and flexible tool than the crawling peg, in which exchange rate changes depend on official decisions. But the change is mainly one of degree rather than substance. The new arrangement converts changes in the exchange rate to an obvious process and frees them from the superfluous birth pains that are a natural consequence of the manner in which an administrative mechanism operates even when the official philosophy professes continuous exchange

rate adjustments. In addition, this arrangement permits drops in exchange rates even during a general upward trend, which is an important advantage in coping with speculative capital movements.

The liberalization of capital transactions creates a greater integration of the domestic financial market with the local foreign exchange money market and foreign markets. This integration, together with the floating rate, broadens the choice of tools available to monetary policy and increases the flexibility of their application in order to influence the exchange rate. Of course, this is not a one-way street, and increasing the degree of integration means greater sensibility of financial variables and more intense changes.

Such a situation increases the force of the factors with which monetary policy must deal and sharpens the dilemma which may confront it: whether to defend its monetary goals at the expense of the exchange rate, or defend the exchange rate at the expense of forfeiting monetary goals.

It should be emphasized that this is not a case of a freely floating rate (which only exists today in economic literature), but rather a managed float, in which there is governmental intervention in the foreign currency market. No matter what the definitions of the goals and rules of intervention may be, a key component in exchange rate determination is an interpretation of market trends and the needs of the economy, by the economic policy.

The targets of exchange rate policy are naturally dictated by the current account position, in conjunction with long-term capital trends. It is guided by the need to ensure suitable competitiveness of the economy. This situation greatly limits the scope for using the exchange rate to cope with short-term capital movements.

Capital movements are occasionally characterized by large changes due to short-term factors (adjustments to long-term factors are in the first stage also characterized by stock adjustments which are reflected in sharp fluctuations for a limited period). These changes are naturally more prevalent when the basic balance of payment situation is not an equilibrium one. They are liable to push the exchange rate in directions and by magnitudes which contradict basic balance of payments goals. The exchange rate cannot be used to deal with such factors without inexorably forcing concessions in basic balance of payments goals. This problem is far more acute in situations which are not basically equilibrium situations.

Floating by itself is not a solution to the balance of payments problem. It is related more to the technical level. A rise in the nominal exchange rate, which is the immediate expression of balance of payments difficulties under a floating rate, is not in itself a solution to the problem. The main problem is still how to ensure that a nominal change in the

exchange rate will be converted into a real change, and not into an inflationary spiral. This can only be ensured by applying an overall economic policy which guarantees proper management of the economy and the achievement of the requisite structural changes. The absence of such a policy will be reflected, even under the new regime, by the same familiar phenomena: a spiral of rising prices and wages, exchange rate rises, and economic recession of one degree or another.

The new foreign exchange regime represent no significant departure from the point of view of the basic balance of payments problems. On the contrary, the application of effective means to deal with these problems is a necessary condition for the smooth functioning of the new regime. The lack of effective treatment and the existence of basic disequilibrium in the balance of payments creates a potential for sharp fluctuations in short-term capital movements. Under the new conditions such a situation is liable to exacerbate the monetary regulation problems of the economy.

Following the new arrangements, an additional system of foreign currency deposits was created in Israeli banks. These can prevent a rise in the exchange rate without losing reserves. But this is mainly a fair-weather device. Under serious pressures, the transition to foreign currency assets is liable to cause an exit of capital and a drain on reserves.

The exchange rate unification plays a central role. The need for a uniform exchange rate and recognition of the harm caused by exchange rate differentials are central to economic analysis. Exchange rate unification eliminates a serious distortion and is an important step towards increased efficiency<sup>25</sup>. An important contribution in this respect is the equalization of the exchange rate for service and goods exports, though naturally those service items deemed important enough to get special incentives in the past benefited from only a slight effective devaluation<sup>26</sup> (for tourist revenues, for example, a devaluation of 16 percent, compared with an average of 44 percent in revenues from service exports in general (see Table V-13).

But the unification of exchange rates involve some problematical aspects: (a) unifi-

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<sup>25</sup> But it should be borne in mind that a unified yet inadequate exchange rate is liable to be just as serious a distortion as exchange rate differentials for different transactions.

<sup>26</sup> Service exports do represent about 45 percent of total exports in the balance of payments, but substantial sections of it have a very low sensitivity to exchange rate changes: revenues from interest, insurance services, transport of import and export cargo, expenditures of foreign companies for activities in Israel and expenditures of Israeli companies for activities abroad, etc.

cation towards which rate<sup>27</sup>? (b) does not the elimination of some exchange rate substitutes while removing differentials in one direction increase them in other directions? (c) the question of the adjustment process – to what extent does the change require a necessary transition period, whose absence involves a resource waste and unnecessary difficulties? (d) the broader aspects of balance of payment goals – what impact does unification have on the ability of economic policy to achieve its exchange rate targets?

The unification of exchange rates naturally involved very unequal devaluations for different sectors. It included a relatively small change in the exchange rate for the value added in industrial exports<sup>28</sup> compared with other exchange rate changes and compared with the price and cost changes triggered off by them. The unification was centered around an inadequate exchange rate in terms of longer-term balance of payments goals. These two facts represent problematical developments for industrial exports.

The high devaluation rates for imports spurred increases in the prices of domestic goods and wages. These pressures from the cost side were reinforced by developments on the demand side. Due to the cost increase potential that has accumulated here, only part of which has been realized, the miniscule rise in the exchange rate of value added is insufficient to ensure real changes in profitability.

Of particular interest is the comparison with the previous large devaluation at the end of 1974. The ratio between the exchange rate rise for value added and the cost inflation effects of the devaluation was much more in favor of the former in the previous devaluation, and the restraint of demand was also more effective. These conditions were reflected in a rise of 7 percent in the profitability index, which was maintained for nine months. Subsequently this improvement began to erode as wages and domestic inputs began to catch up, and economic policy was caught by the dilemma between the needed devaluations in order to maintain the profitability of exports and the inflationary results of these devaluations under insufficient restraint conditions.

The reform brought about a 2 percent change in the profitability index, and apparently its initial conditions from the aspect of the advance of the exchange rate increase for

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<sup>27</sup> We consider here the exchange rate as a variable determined by economic policy (see above).

<sup>28</sup> The question of measurement is a problem here. If we refer to the exchange rate immediately after the foreign currency reform, then the change regarding value added is very small. We refer here to the last two months of the year, and not just to the stage immediately following the reform.

value added and the potential cost rise caused by it, are much worse than in the previous devaluation, so that prospects are less rosy.

A problem of a different sort was created by unification around an inadequate exchange rate. The former arrangement of exchange rate differentials between exports and imports was to all opinions inefficient, and made possible exporting that was unprofitable to the economy. A shift to exports with low value added benefiting from supports intended for exports with high value added made possible exports that could survive only at very high rates to value added. But it should not be assumed that all export sustained by this arrangement was unprofitable under all conditions.

A prime objective of government policy was to raise the real exchange rate for export. If just prior to the reform the rate for value added in export was, according to calculations, based on assumptions regarding the percentage of value added, more than IL 14.5, then an export which – to use a rough estimate – fell in the range between IL 14.5 and IL 17 to value added was a worthwhile export for the economy. This is essentially the same export in which the economic policy invested great efforts to render profitable by its devaluation policy. Unification of the exchange rates around IL 15 at end of October prices hits this export. The magnitude of this type of export is unknown, but there is no doubt that it exists and that a problem has been created. It could have been anticipated that this problem would confront the economic policy with a dilemma: be resigned to the damage wrought upon profitable export firms or search for a substitute to indirect support arrangements whose effectiveness is smaller and whose indirect effects are far more damaging.

Another, less apparent problem was created by the fact that the unification of exchange rates did not remove all exchange rate substitutes. While with regards to exports the elimination was complete, in imports there was only a very partial cut of tariffs on competing imports. This led to a substantial increase in the exchange rate differentials for value added between export and import substitutes benefiting the latter<sup>29</sup>, which meant damage to economic efficiency<sup>30</sup>. It appears that consideration of both long-term economic efficiency and economic management justify much larger cuts in tariffs. These need not necessarily be uniform, but should place a more pronounced emphasis on the higher levels of the protection scale. Such a step will also serve to check price rises.

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<sup>29</sup> See the estimates of Yosef Baruch in the Bank of Israel Survey, no. 48 (forthcoming).

<sup>30</sup> On the other hand, there is a decline in the rate of protection for value added in import substitutes compared with the official rate, which suggests a reduction in the exchange rate differential for protected import substitutes relative to import substitutes which do not benefit from tariff protection (if any), or potential import substitutes.

The large rise in the exchange rate for capital transactions have negative repercussions on the central goal of the economic policy: ensuring a real exchange rate change. This is the result of both the expansive effects of capital gains and the rise in revenues, whose source is the large increase in the exchange rate at a time when a restraining policy was called for, and the fact that granting substantial capital gains and income increases to a few sections of society hampers the Government's ability to implement a restraint policy successfully.

The changes regarding capital transactions are likely to cause a certain short-term increase in capital import, however, in the long term they will apparently have only a marginal effect. There is a certain long-term benefit in the removal of restrictions on withdrawing capital, which increases the attractiveness of domestic assets to potential investors<sup>31</sup>. On the other hand, the negative effects of the basic economic situation remain, subject as it is to balance of payments difficulties and conditions of economic slackness.

Regarding short-term factors, there is reason to expect substantial changes over a limited time. The large increase in the exchange rate for capital transactions means large capital gains for owners of foreign currency assets and a drastic change in the expected relative profitability of domestic assets. These factors generate a portfolio adjustment process involving a shift from foreign currency assets to domestic assets. This kind of process, in which stock adjustments play a prominent role, is naturally of limited duration. Under present circumstances, with no basic solution to the balance of payments problem in sight, its duration will be even more limited, and it can be expected that its effect will shortly be exhausted<sup>32</sup>.

This is the basic pattern which has characterized adjustment processes in the financial field following exchange rate changes. The pattern has apparently become much more complex due to the changes following the foreign exchange reform.

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<sup>31</sup> This point is perplexing from certain points of view. For potential capital transferers among foreign residents, almost all restrictions were cancelled in 1968. The concessions adopted now apply mainly to Israeli residents, but they can hardly be a source of capital import, except in regard to assets held abroad illegally.

<sup>32</sup> It should be recalled that after the previous large devaluation of November 1974 (which was also characterized by similar differentials: 43 percent for capital imports, 22 percent for imports, and 21 percent for exports), there was a substantial increase in private capital transfers, which lasted about 6 months. It can be safely assumed that if the required basic changes are not achieved in other areas, a similar development can be anticipated this time as well.

The transition to Israeli currency assets, in which a price adjustment had been expected following the large devaluation, was completed more rapidly than usual. There were several reasons for this: there was rapid accumulation in the savings programs due to special benefits and the announcement of a termination date, while there was a rapid adjustment of rates in linked bonds on the secondary market<sup>33</sup>. This rapid adjustment reflects the standstill condition in the new issues market, and its failure to provide a supply of new bonds. Once this stage of transition to Israeli currency assets terminated, a rapid accumulation of foreign currency deposits commenced in the banks. This process apparently did not reflect rising expectations that a depreciation of the pound would ensue, but stemmed from the altered arrangements, which presented a new type of asset to the general public. The large-scale transition to this asset began only after the adjustment of rates in linked bonds had concluded. Under the new conditions, these deposits apparently represent a new tool for protecting wealth from inflationary erosion. This transfer may partly reflect a general awareness of the balance of payments situation, but not expectations of immediate substantial changes in the exchange rate of the Israeli pound (though the transfer itself may have contributed to the depreciation of the pound).

Apparently in the months following the reform, the public adjusted its portfolio in favor of assets in Israeli currency. This process was accompanied by a transfer of assets held by the private sector from abroad. During the first quarter of 1978, there was a change in this respect, and the private sector shifted from a position of net foreign currency vendor to that of large-scale net purchaser. This may have been a return to the basic pattern of financial flows after the portfolio adjustment was completed, but there may also be an element of another stock adjustment, as new transactors, for whom the reform opened the gates, joined those holding assets abroad.

One other complex adjustment factor must be pointed out. Credit in Israeli currency was becoming more expensive throughout 1977. The large devaluation in October, together with the change in expectations it created, greatly cheapened the price of foreign currency credit, and this was reflected in public behavior. During the same period, a decline in nominal interest (which in any case was low), on the directed part of this credit source, under conditions of lowered barriers and increased financial integration between Israel and the rest of the world, could have a substantial effect on the flow of short-term capital abroad.

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<sup>33</sup> A rise of 24 percent between October and December (while the price index rose by only 12 percent), which caused a substantial decline in the rate of return.

With the exception of short-term adjustments, there is apparently no reason to expect any significant change in capital flows as long as the basic alignment of forces by which capital import has been influenced in recent years remains: there exists a balance of payments problem and the need for a real exchange rate rise on the one hand, and the economic ebb and serious damage to domestic profitability on the other. It was this alignment of factors, and not the stricter control, which caused the steep decline in capital imports since the balance of payments crisis and the economic stagnation.