

CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

Most of the trends that characterized Israel's economy in the previous year carried over through 1977. The import surplus was reduced and there was an improvement in its sources of finance. The further vigorous strides made by exports on the one hand and the deepening of the slump in construction on the other resulted in a niggardly economic growth this year as well. As in 1975-76, unemployment did not increase to any significant extent. The high rate of inflation evident in the past few years continued unabated in 1977, but there was some change in the underlying causes in the last two years: wage-push grew stronger while the contribution of taxes declined.

At the end of 1977 an economic reform was introduced, the main features of which were the liberalization of foreign currency control, the unification of exchange rates, and the floating of the Israeli pound. In the few months that have passed since then the new policy could not of course make its long-term impact fully felt; its immediate effects were a sharp devaluation of the IL and a steep jump in prices.

The balance of payments picture continued to brighten in 1977, in line with the trend noticeable the year before: the deficit on current account shrank from about \$4 billion in 1975 and \$3.3 billion in 1976 to approximately \$2.5 billion. The improvement during this period was almost equally divided between the two principal components: the civilian current account and direct defense imports. In 1977, however, the contribution of non-civilian imports was dominant, contracting by about \$550 million (CIF), as contrasted with some \$250 million in the civilian deficit.

In the last two years direct defense imports sank to about half their level in 1975 (in constant price terms). This improvement was also reflected in the proportion of imports covered by exports: whereas overseas sales covered some two-thirds of the import bill in 1972 and only about half in 1975, the ratio reached 70 percent in the year reviewed. The bolstering of the civilian current account position can be credited to a healthy gain in exports and the sluggish expansion of imports. The export advance came to 13 percent, similar to the figure posted in 1976, while imports increased a little faster this year.

As for the capital account, the year reviewed saw a further diminished reliance on inconvenient sources of financing. Another notable development was the smaller capital inflow of the public sector and the consequent reduction of its weight in total capital

TABLE I-1
MAIN ECONOMIC INDICATORS, 1971-1977^a
 (percent annual increase)

	Average			1971	1972	1973	1974	1975	1976	1977
	1961-65	1966-67	1968-70							
Resources and uses (in constant prices)										
Total domestic uses	10.5	1.4	14.5	8.2	7.5	16.9	3.6	4.2	-3.7	-4.8
Gross domestic product ^b	10.0	2.0	12.5	11.0	12.1	5.0	4.6	3.8	1.5	0.6
Gross domestic product-business sector (excl.residential rents) ^c										
Total	10.9	-0.1	14.5	12.4	13.9	2.1	4.0	3.5	0.6	-0.6
Per employed	6.1	3.7	8.6	7.1	6.2	-2.2	4.7	3.8	0.0	-2.6
Real disposable private income	10.6	3.5	8.7	12.7	14.3	9.8	4.1	-0.6	-5.7	5.8
Private consumption	10.3	2.3	8.4	5.8	9.9	8.5	8.4	0.1	4.6	3.5
Total	6.1	-0.6	5.2	2.5	6.3	5.0	5.2	-2.2	2.3	1.2
Per capita	10.6	21.4	17.1	1.3	-1.9	46.4	2.1	10.0	-8.7	-13.9
Public consumption										
Thereof: Civilian consumption		5.4	5.3	5.1	7.9	6.9	4.0	4.6	5.0	2.6
Weight in GNP (percent, in current prices)										
Public sector income, ^e less subsidies					36.2	33.6	38.6	37.9	44.7	43.6
Liquidity absorption ^f					24.5	20.4	22.2	19.7	24.3	23.3
Public sector demand surplus					5.5	13.3	15.5	17.1	9.5	9.2
Gross domestic investment	11.3	-19.1	28.5	21.8	12.8	5.2	-3.3	5.0	-12.5	-10.4
Public sector ^g				29.9	21.4	7.3	5.1	11.0	-18.7	-22.7
Other, incl. ships and aircraft				18.6	9.4	4.2	-7.4	1.7	-8.9	-3.9
Balance of payments, ^h excl. trade with administered areas (in dollars)										
Imports	12.0	7.2	22.0	16.7	6.5	62.7	29.8	11.4	-1.3	5.0
Exports	15.6	11.4	13.5	31.8	17.5	25.4	29.4	2.7	7.0	26.5
Import surplus (\$ million)				1,264	1,150	2,660	3,462	4,155	3,452	2,739
Foreign currency debt (\$ million)				3,430	4,081	5,093	6,250	7,617	9,371	10,715
Foreign exchange reserves ⁱ (\$ million)				575	1,070	1,697	1,071	1,040	1,156	1,359

Population and employment										
Average population	3.9	3.0	2.9	3.0	3.3	3.3	3.0	2.3	2.3	2.2
Number of Israeli employed	4.8	-2.5	4.8	3.5	5.0	3.9	0.3	1.5	1.3	2.9
Unemployment rate (as % of civilian labor force), absolute figures	3.6	8.9	4.8	3.5	2.7	2.6	3.0	3.1	3.6	3.9
Prices and national income (nominal)										
Average monthly earnings per employee post ^l	13.6	9.4	6.1	16.4	13.6	27.5	36.1	36.7	32.6	47.6
GNP price deflator	8.0	4.8	4.4	12.7	14.4	21.0	34.9	37.3	26.7	42.0
Import prices ^k	9.7	2.1	7.7	16.1	20.5	39.2	41.7	33.0	41.4	
Consumer price index (annual average)	7.4	4.8	3.6	12.0	12.9	20.0	39.7	39.3	31.3	34.6
National income	18.8	6.5	17.0	25.3	28.9	26.3	39.0	39.6	25.8	42.1
Finance (annual average)										
Money base ^l	18.9	13.6	11.6	34.6	47.5	24.0	5.4	26.4	18.0	49.0
Money supply	17.6	13.6	10.2	22.4	30.1	25.3	19.8	31.0	17.7	40.5
Other liquid assets of the public	32.5	23.7	26.5	29.8	27.6	21.3	23.6	48.6	36.8	59.8
Bank credit to the public ^m	19.6	20.9	16.0	24.1	17.4	26.8	48.4	53.0	34.0	56.0

a Until 1968 the percentage changes were calculated on the basis of the previous year's prices. From 1969 to 1975 the rates of real change were calculated on the basis of 1970 prices, and since 1976 they have been calculated on the basis of 1975 prices.

b Valued at the effective rate of exchange.

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

d Gross disposable private income from domestic sources, before deducting compulsory loans.

e Revenue from taxes (except that on defense imports) and compulsory loans and property and entrepreneurial income.

f Public sector revenue, less net transfer payments.

g Government, local authorities, National Institutions, government business-type enterprises, nonprofit institutions, and public residential construction.

h Goods and services (imports CIF, commodity exports FOB, and service exports valued on the basis of CIF recording of commodity imports).

i Net foreign current balances in the Bank of Israel at the end of the year.

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

k Includes changes in foreign prices and in the effective exchange rate of the Israeli pound.

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

m Until 1970 includes bill brokerage credit.

SOURCE: Central Bureau of Statistics and Bank of Israel data.

imports - an outcome of the contraction of defense-related U.S. government aid. As in 1976, the import surplus was covered by long-term capital imports. The country's foreign currency debt continued to grow, but more modestly than in previous years. Net long-term borrowing came to roughly \$500 million in 1977, about a third of the 1975 volume.

The acceleration of civilian imports this year occurred in commodities, which was not fully offset by the decline in invisibles. As in 1976, there was a sluggish increase in current production inputs and a further drop in capital goods; by contrast, purchases of rough diamonds rose precipitously because of speculative stockpiling.

While the overall rate of export growth was about the same as in 1976, the dominant factor this year was the stronger advance of services, which offset the slackening of the uptrend in commodities. Most of the additional proceeds from services originated in tourism; noncivilian products and polished diamonds were responsible for the slowdown in commodities. Manufacturing exports excluding defense equipment moved up 15 percent, about the same rate as in the previous year. The headway made by agricultural exports was also roughly the same as in 1976 (despite the slumping of citrus sales).

As in 1975-76, the performance of the economy lacked lustre: growth was trifling and the already low capital and labor utilization rates dipped further. The gross domestic product crept up 1.3 percent¹. The second half of the year saw some signs of a recovery in demand, especially in the home construction market.

The naggingly sluggish growth of economic activity was dictated in 1977 too by developments on the demand side rather than the supply of capital and labor. The previous year's trends apparently persisted: a slight downswing in public domestic consumption and the cutting back of investment, especially in residential construction, on the one hand, and a vigorous expansion of exports and a slow increase in per capita private consumption on the other. Total resource use (excluding direct defense imports and the ships and aircraft item) rose to the same extent as in 1976 about 2 percent. This similarity in the overall volume, however, masks a disparate development in two major spheres: the public sector's influence on economic activity and the rate of national saving.

A yardstick of the public sector's impact on economic activity is its domestic demand surplus, i.e. the excess of its domestic expenditure over its inland revenue. The demand surplus, after bulging steadily in the post-Yom Kippur War period (bringing up its weight from 5.5 percent of GNP in 1972 to a high of 17 percent in 1975), shrank in 1976 to 9.5 percent of GNP because of an increased fiscal absorption and the curtailing of expenditure.

¹ Measured from the demand side (the method used in this Report), the increase was 1 percent; the 3 percent figure was yielded by indicators of the industrial origin of GNP.

It tapered off at this level in 1977, owing to a slight contraction of the sector's direct demands and of the amount siphoned off from the public.

Domestic defense spending by the public sector was down 5 percent (a slower decline than in 1976), while its civilian expenditure continued upward at a 4.5 percent real rate. Another striking feature this year was a steep jump in the sector's real wage outlay, which had an expansionary effect on demand. Direct investment sagged more modestly than last year, but residential building fell off more steeply.

The fiscal absorption from the public slowed in 1977: taxes and compulsory loan proceeds trailed behind the rise in private income, yielding only 4 percent more this year in real terms (compared with 16 percent in 1976). Transfer payments were up 5 percent after rising 12 percent in each of the two preceding years.

As already mentioned, the net effect of the public sector's operations on demand leveled off this year, or may have been slightly stimulative.

Real private consumption per capita inched up about 1 percent, after increasing 2.5 percent in 1976. Following a 3.5–4 percent growth of disposable income per capita, the rate of private saving went up a notch in 1977, reversing the sharp downswing of earlier years, especially in 1976. The drop in the saving rate until 1976 is apparently explained by the lagged adjustment of consumption to the change in income and by the mounting share of wages in national income; in 1977 this lag was reduced, as consumption probably responded a little less quickly to the increase in disposable income. Also contributing to the better saving performance this year was the payment of significant retroactive wage adjustments, the propensity to save from which is low. The decline in the saving rate in 1976 apparently helped to moderate the economic slowdown that year, but the slight upturn in 1977 did not have any significant impact on demand.

Capital formation (excluding ships and aircraft) fell 12 percent – similar to the 1976 figure. The outstanding development here was the aggravation of the decline in residential building from 13 percent last year to 22 percent, owing to the deepening of the slump in public home construction. In the second half of 1977 an excess demand for housing developed, sparking a precipitate jump in prices and the rebounding of private housing starts.

Nondwelling investments were cut back 8 percent (as in 1976), due to the slack growth of the economy, which mainly affected capital spending by the business sector, and also because of the restriction of public sector and nonprofit institution investment. The availability of directed (subsidized) financing had a stimulative effect, blunting the influences working in the opposite direction.

The business sector product² rose about 3 percent, after expanding by 10 percent or more per annum before the Yom Kippur War. The paltry gains in 1976–77 can be largely attributed to the conspicuous retreat in construction, where the figure dipped 13.5 percent each year. Disregarding this industry, the business sector product was up about 5 percent, and less the change in construction-related industries, the advance was bigger yet. Agriculture, manufacturing, and transportation and communications moved up to the same extent as in 1976 – 9, 4, 5, and 8 percent respectively.

The expansion of the total product reflected mixed trends: exports added 5 percent and private consumption 1 percent; investment and public consumption (notably noncivilian) worked in the opposite direction, depressing the level by 2.5 and 0.5 percent respectively.

The growth of exports embraced all sectors of the economy: manufacturing, agriculture, and services (tourism). After an unimpressive rise in 1973–74, exports forged ahead at a vigorous pace in the last two years, the advance actually constituting a turning point. The rate of growth during these two years even surpassed the estimated percentage increase in the economy's production capacity.

Most of the thrust in 1977 came from domestic factors: the weakening of the home market and the increased profitability of exports; the contribution of foreign market growth, on the other hand, shrank to about half compared with 1976. The subsiding of domestic demands reduced, of course, the attraction of the local market, and this, coupled with the buildup of spare capacity, led to the diversion of resources to export.

The relative profitability of exports continued upward this year; i.e. there was a modest increase in profitability relative to inputs, and there was also an increase relative to production for the domestic market. Real wages paid by exporters outpaced the rise in labor productivity in the last two years. This was a disquieting development (even though in the three preceding years they trailed behind), for a rise in wages relative to labor productivity makes it less worthwhile in the long run to hire additional workers for stepping up export production. In this connection it should be pointed out that these profitability indicators do not reflect the export incentives granted in the form of directed credit for financing investments and working capital requirements.

² The business sector product is defined as the total product less wage outlays in the public services and imputed residential rents. The figure appearing here was obtained from indicators of the change in the product originating in the various industries. An alternative measurement from the demand side points to stagnation.

The laggard expansion of the product in the last few years was due, as stated, to the shrinkage of demand rather than supply. While the economic slowdown was accompanied by the sluggish growth of labor and capital, it seems that the actual increase in the product limped far behind that in production capacity, depressing the factor utilization rate, especially in the case of capital. The productivity of capital, measured as the ratio between the stock of capital assets and the business sector product, has shrunk 30 percent since 1972, after it had gone up in the previous period — evidence of the low capital utilization rate.

The input of manhours in the business sector did not rise at all during these five years, with the result that labor productivity (measured according to manhours worked) went up by about 2 percent a year, as contrasted with 5–6 percent p.a. in the six years previous to 1972. An industrial analysis of labor productivity points to a large-scale disguised unemployment and a drop in labor productivity in construction, in contrast to the picture in the previous slump period. Manufacturing too experienced a somewhat slower growth of productivity, notably in construction-related industries.

A measurement of the slack in production capacity entails strong assumptions. Assuming that the return to productive factors reflects their contribution to the product and that productivity continued upward at a rate similar to that in 1966–72, we can conclude that the actual product amounted to only 80 percent of its potential, given the expansion of capital and the actual labor input.

This idle capacity was created against the backdrop of the balance of payments crisis that arose in the post-Yom Kippur War period, which made it imperative to curb the growth of imports and to boost exports to the utmost. This highlights the problem involved in taking up the slack in capacity. In the case of construction-related industries and those geared mainly to the local market, this necessitates the stimulation of domestic demands. But this in turn would lead to a sizable rise in imports and the import surplus, which would surpass the economy's capital import — unless export production could be significantly stepped up and the expansion of domestic uses limited so as to stave off the widening of the import surplus.

Wages rose strongly in both the public and business sectors in 1977. In terms of employees' purchasing power, the gains came to 7 percent in the business sector and 14.5 percent in public services. These increases include retroactive pay adjustments and the withdrawal of profits in the form of managerial salaries, amounting to an estimated 3 percent in each sector.

The advance of real wages (from the employees' viewpoint) was one reason for the rise in the civilian labor force participation rate, for the first time since 1974. Regarding the

demand for workers, the picture is not very clearcut. The expansion of foreign sales led to the growth of employment in export-related industries. On the other hand, the reduction of output in construction and allied industries had a dampening effect on employment (which declined by less than called for by the slackening of activity). It is hard to judge which of these two trends was the dominant influence on overall demand for labor in the business sector. Nevertheless, it seems that the increase in real wages was lower from the producers' viewpoint, only slightly outpacing the advance in real product per man-hour. This was consistent with the stability, and perhaps even some growth, of the demand for labor during the year.

The developments in the labor market – the expanded supply of workers and the mixed demand trends – led to an insignificant increase in unemployment in 1977. It would seem that the protracted slowdown in economic activity over the past three years should have sharply depressed demand for labor and put many workers out of their jobs, as happened during the 1966–67 recession. But, as stated, this did not materialize; instead there was an increase in disguised unemployment. We do not have a full explanation of this phenomenon; it was apparently connected with producers' expectations of a resumption of the domestic market boom on the one hand and with the difficulty of laying off redundant labor on the other. Other factors checking the growth of overt unemployment were a reduction in the number of workers from the administered areas, the smaller number of hours worked per employed because of the business situation, and a big increase in public sector personnel, which accounted for most of the incremental manpower hired in recent years. Along with the ebbing of demand, the three years 1974–76 witnessed a more sluggish growth of the labor supply. The expansion of the working-age population slowed with the drop in (net) immigration, and the labor force participation rate dipped steeply.

Some signs of recovery appeared in the labor market during the year reviewed. The civilian labor force participation rate turned upward and there was a rise in employment in the business sector (excluding construction).

The high rate of inflation evident since the end of 1973 carried over through the year reviewed. The Consumer Price Index jumped 43 percent, after rising 38 percent in 1976.) It did not move up at an even pace during 1977: initially the advance was more moderate, mainly because of the slower implementation of mini-devaluations and the heavier subsidization of basic commodities. In the middle of the year, after the elections, a series of mini-devaluations and the paring of subsidies in the wake of the wage increases awarded in the early months, inflation escalated. After the economic reform, which inter alia made imports much dearer, the Consumer Price Index went up by a daunting 14 percent within two months.

The inflation began, it will be recalled, with the oil crisis and the soaring of prices of this and other primary commodities in the world markets, which worsened Israel's terms of trade. These extra costs pushed up domestic prices on the one hand and eroded the country's balance of payments position on the other – a development exacerbated by the heavier public sector defense spending after the Yom Kippur War. The aggravation of the economic situation induced the government to take action to dampen private consumption, encourage exports, and curtail imports. These measures, which included the devaluation of the currency and the stiffening of taxes, helped to put a damper on economic activity and strengthen the balance of payments. But the price paid for this was the upward spiraling of wages, prices, and the exchange rate, which did not subside even after the buildup of considerable excess capacity in most sectors of the economy, for no substantial overt unemployment appeared which might have retarded the wage-price spiral to some extent.

The advance of prices in 1977 was by and large a continuation of this process. However, in the last two years there was some change in its character. First of all, the importance of taxes declined: tax rates were not revised in the year reviewed, so that the direct contribution of this source to the price increases weakened. Secondly, wages generated more upward thrust on prices than before. The big pay hikes awarded were far greater than justified under the cost-of-living allowance arrangement and the original wage pacts signed. Although the reasons for the steeper advance of wages in 1977 are not very clear, it can probably be attributed to the greater bargaining power of workers in an election year and the rapid structural change in the demand for labor.

Monetary expansion accelerated greatly in 1977, as reflected by the amount of bank credit provided to the public and by the money supply. This mirrored the changes that took place in the capital market this year: the growth of total household financial saving and a conspicuous change in the component items.

The rise in the rate of national saving and the change in its composition were reflected by a big increase in financial saving, which was funneled to the share market and long-term thrift schemes. At the same time, the public's direct holdings of indexed bonds shrank. These changes, coupled with that in the distribution of private saving between households and business, directly and indirectly stimulated demand for money and credit, which mounted at a faster pace than required for financing the modest level of economic activity in 1977.

In view of the impressive headway made by exports, the Bank of Israel stepped up the volume of export credit, but in other segments of the capital market it pursued a restrictive policy, jacking up the cost of directed and nondirected credit alike. The expansion of the money supply and credit was apparently accompanied by some increase in the real

rate of interest in the money market: the effective rates on nondirected credit and directed export credit rose during 1977; part of the directed export credit was shifted from local to foreign currency, and this too brought up the effective interest rate somewhat. Together with this, the interest paid on IL time deposits was hiked a bit. Until the end of October, i.e. before the economic reform was introduced, inflation had been running below the 1976 rate, and hence it is reasonable to assume that in the eyes of borrowers the real rate of interest did in fact go up.

The steps taken by the Bank of Israel were incapable of forestalling the rapid monetary expansion that took place before the reform went into force. The advance of real interest rates on the various types of credit weakened, but did not prevent, the mounting of demand for credit, which was apparently intended for financing speculative import transactions in anticipation of an increase in foreign prices and a devaluation of the IL, as well as for financing speculative transactions on the stock exchange. In the productive segment demand for short-term credit probably did not grow in 1977, for the incremental long-term financing made available during the year exceeded the extra capital spending.

The economy's liquidity, as reflected by the money base, continued to expand strongly, for the second consecutive year: the increase came to 46 and 48 percent during 1976 and 1977 respectively, after a mere 5 percent rise in 1975. This rapid growth stemmed primarily from the sizable, steady government liquidity injection, and from the larger volume of Bank of Israel rediscounts for financing exports, which were not offset by the absorption of money from the private sector through foreign currency purchases.

Whereas in 1976 the money supply and credit to the public trailed far behind the growth of the money base, in 1977 the picture changed: the money base expanded by 48 percent, followed by a slightly slower (39 percent) rise in the money supply and a formidable 75 percent spurt in bank credit to the public. The divergent pattern over the last two years, despite the similarity in the overall liquidity inflow, is explained by the monetary policy measures adopted, which led to the reduction of the banks' liquid asset shortfalls in 1976, and by the much larger volume of share issues floated by commercial banks in 1977, which placed at their disposal substantial resources not requiring liquid asset cover.

The rapid monetary expansion in itself caused a relatively small increase in aggregate demand and in the rate of price rise, for at the same time there was a much more buoyant demand on the part of the public for holding liquid assets, which was related to the capital market developments. It can therefore be said that the impact of the appreciable liquidity infection since 1976 on economic activity and the price level was temporarily blunted in these two years: in 1976 because of monetary policy measures that prevented the extra

liquidity from fully influencing the monetary variables – money and credit; and in 1977 because of capital market developments which prevented the monetary expansion from finding full, immediate reflection in the level of economic activity and the sharpening of inflation.

At the end of October 1977 a sweeping reform was introduced in the balance of payments sphere: foreign currency control was liberalized, there was a shift from a system of creeping devaluation to the floating of the IL; and exchange rates were unified for all foreign currency transactions. The liberalization mainly took the shape of the scrapping of most restrictions on foreign currency transactions by local residents and the permission granted them to hold foreign currency in Israeli banks, and to a lesser degree the abolition of the remaining curbs on the transfer of money by nonresidents. In addition, individuals and companies were allowed, on certain conditions, to hold deposits in banks abroad, up to a certain limit.

The changeover from mini-devaluations to a floating exchange rate was designed to basically alter the nature of the Bank of Israel's intervention in the foreign exchange market and to reduce the scope of such intervention. No longer will the exchange rate be fixed administratively, nor will the foreign exchange market be balanced mainly through changes in the economy's foreign exchange reserves. From now on the exchange rate will be determined more by the demand and supply of foreign currency, on both current and capital account. The central bank's intervention has been reduced, and is now limited chiefly to moderating the influence on the exchange rate of random short-term fluctuations in the demand and supply of foreign currency.

The unification of exchange rates for all foreign currency transactions on current and capital account was intended to eliminate the distortions produced by the system of multiple effective exchange rates, and to avoid the appearance of more serious distortions which would have arisen if the differential rates were maintained. Export subsidies and the defense levy on imports were abolished and customs duties trimmed. But the continued existence of protective tariffs results in discriminatory exchange rates on the import component of the various uses. The rate of protection on import substitutes has even risen relative to the exchange rate for exports, thereby creating a distortion which in the future will necessitate the substantial lowering of the abnormally high protective barriers. The profitability of industrial exports has been preserved after the devaluation and unification of exchange rates, and the profitability of service exports and import substitutes has even improved.

While each of the elements of the reform taken on its own was intended to enhance the effectiveness of the balance of payments policy measures, there was a close connection

between the liberalization of foreign currency control and the other steps initiated. Liberalization increased the importance of floating the IL, whose aim was to avert the negative repercussions of short-term capital movements, so that they should not lead to a sizable depletion of foreign exchange reserves or to undesirable changes in the monetary variables. The abolition of multiple exchange rates was another necessary concomitant of liberalization, since such a system could not be maintained without controls to prevent the acquisition of foreign currency at one rate and its sale at a higher rate. Finally, the rates could not be unified without a one-time big official devaluation of the Israeli pound so as not to harm exports, which had enjoyed the highest effective rates of exchange.

It is too early to gauge the full implications of the reform on economic developments. But in several spheres the October measures had an immediate effect, including a steep jump in the exchange rate, a noticeable sharpening of inflation, and the swelling of the foreign currency components of the money market. As regards the accelerated rise in prices, the preservation of export profitability after abolition of the export subsidies and the defense levy on imports and the lowering of customs made it imperative to raise the official exchange rate by a steep 47 percent. All these made imports 26 percent dearer. The Value Added Tax was temporarily hiked by 4 percentage points and subsidy rates were adjusted; these changes pushed up the price level by an estimated 10-12 percent at one stroke. The spiraling of prices was apparently one of the reasons for the subsequent pressing of wage demands by labor despite the advance payment of a cost adjustment in January.

Regarding the foreign currency components of the financial market, the reform transformed the monetary scene, compared with both the first ten months of 1977 and with the situation after previous devaluations. After a brief period of foreign currency conversions and growth of indexed saving schemes, at the end of 1977 and in early 1978 foreign currency deposits in local banks began to swell. This was apparently one immediate manifestation of the liberalization, and it took place simultaneously with the contraction of the money supply and time deposits in Israeli currency. There was also an immediate increase in foreign currency credit and only a mild one in that granted in Israeli currency, because of the restrictions imposed on credit expansion.

The rapid response of the exchange rate to changes in the demand and supply of foreign currency became much more urgent after liberalization, which opened the economy to short-term capital movements. The changes in the demand for foreign currency since the reform have in fact produced a rapid, elastic response of the rate, which rose about 10 percent between the end of October 1977 and the end of April 1978. These changes, however, have had only a minor effect on the country's foreign exchange reserves. Apart from the first few days after the reform, when the Bank of Israel absorbed the excess

supply of foreign currency in order to stave off a temporary plummeting of the exchange rate, the Bank has not intervened to prevent market forces from influencing the rate, as is attested by the development of the rate, foreign currency purchases, and foreign exchange reserves.

It should be stressed that the floating of the IL will not in itself resolve the balance of payments problem. A rise in the nominal exchange rate, an immediate reflection of the balance of payments difficulties under conditions of floating rate, does not solve the question of how to ensure that a nominal change in the rate will turn into a real change and not merely give another twist to the inflationary spiral. This can be realized only through a concerted policy designed to ensure the proper management of economic activity. The lack of such a policy under a system of a floating exchange rate and liberalization of foreign currency control will aggravate the wage-price spiral.

Some headway was made in mastering the balance of payments problem in the past two years. The import surplus was pared and its financing improved: the recourse to short-term sources of finance was ended, the bulging of the foreign currency debt slowed, and the economy's foreign exchange reserves expanded. But the reduction of the import surplus was achieved largely at the price of a continued stagnation of the economy, which curtailed imports and facilitated the growth of exports. It would therefore be worthwhile examining whether the policy pursued has created the infrastructure for the renewal of economic growth accompanied by the utilization of spare capacity and the continued gradual contraction of the import surplus.

First, let us see how effective the policy has been in bridling private consumption. The share of private consumption in the national product is determined by the weight of disposable income in GNP and the rate of saving out of such income. Economic policy is likely to influence private consumption mainly by determining the share of disposable income in GNP — i.e. through fiscal absorptive measures. The government's tax and compulsory loan revenue, which amounted to 39 percent of GNP in 1972, reached approximately 50 percent in 1976 and 1977. At the same time, transfer payments and subsidies swelled and compulsory loans were redeemed, so that the net fiscal absorption, after sinking to 18 percent of GNP in 1975, stood at its 1972 level in the year reviewed (about 21 percent); however, the hiking of taxes was one of the factors sharpening inflation. The government's influence on the weight of private consumption in GNP did not change, therefore, in comparison with the period before the balance of payments crisis.

As for public consumption, it should be noted that the total volume (civilian and noncivilian) outpaced the growth of GNP, but whereas the heavy defense spending was an outcome of the Yom Kippur War and its aftermath, the zero increase in the rate of

fiscal absorption from the public and the expansion of civilian public consumption reflect the government's welfare policy: the weight in GNP of public civilian services (nondefense consumption plus nonprofit institution services) and national insurance and social welfare payments has risen precipitously since the prewar period, from 20 percent to 26 percent or more in 1977. It would therefore seem that the target of reducing the share of private and public consumption has not been attained so far.

The share of domestic uses in GNP declined because of the contraction of investment, in particular residential construction. Obviously, policymakers cannot count on the leashing of investment to dampen domestic demands in the future, for realization of the economy's growth potential entails a heavier capital spending. But its share need not return to its previous level, considering the low capital utilization rate, which was evident even before the economic slowdown and has since become more pronounced. The low capital utilization can largely be ascribed to the availability of ample public financing and the appreciable increase in its subsidy element with the intensification of inflation.

Another aspect of the hoped for structural change in the economy is a steady rise in export profitability so as to enable exports to expand at a vigorous pace. But while considerable progress was made on this score in the last two years, the improvement in export profitability was only slight and was due to the weakening of aggregate domestic demand. Hence there is no assurance that the foundations have been laid for a sustained increase in profitability in the coming years. In view of the lacklustre tone of the economy, we cannot fully explain why the high nominal devaluation rates have found only limited expression in export profitability, but have given another twist to the wage-price spiral. Several reasons can be singled out, including the fact that imported input prices outpaced the advance of export prices; this had a direct negative effect on export profitability and helped to sharpen inflation and wage demands. In addition, inflation probably could have been harnessed to some degree if greater stress had been put on cutting the government budget instead of raising taxes.

To sum up, after three years or more of niggardly advance, we should strive for the resumption of economic growth and the utilization of the idle capacity that has built up. A consumption-led renewal of growth is liable to impair the achievements recorded in the balance of payments and to aggravate the inflationary process. The key to the resumption of growth with a continued gradual improvement in the balance of payments and the toning down of inflation lies in reducing the share of consumption in GNP and a sustained vigorous advance of exports, which should rely more on the enhancement of its profitability. This would ensure a consistent, steady strengthening of the balance of payments position coupled with a modest rise in the standard of living. Since the deterioration in the balance of payments, not enough has been done to curtail the share of private and

public consumption in GNP, owing inter alia to the big increase in services provided to the population and in welfare payments. The expedient of resorting to taxes in order to blunt the influence of the accelerated growth of government spending triggered a round of wage demands on the part of labor and aggravated inflation. In the next few years the level of services and transfers for income maintenance should therefore be frozen. The steep jump in wages, especially in the last two years, jeopardizes the continued improvement in export profitability. Hence it is necessary to restrict wage demands in line with the increase in productivity in the economy.

Attainment of the economic targets, namely the resumption of growth together with a further bolstering of the balance of payments and the slowing of inflation, thus depends first and foremost on a fiscal policy that will lead to the reduction of the public sector's excess demand and an income policy that will prevent unnecessary cost-push on prices.