

CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

Israel's economy made very little headway, if any, in 1975, but there was no rise in unemployment. The import surplus, excluding direct defense items and ships and aircraft, shrank a little in real terms and the price advance also slowed (but still remained high).

Economic activity did not trace an even path during the year: it slackened acutely in the first half and turned up a bit in the second. It is important to bear this in mind when assessing the effect of the policy measures adopted by the government in 1974-75 and the outlook for 1976.

A survey of developments in 1975 should not be confined to a comparison with the previous year. The chief criterion for examining and evaluating the economy's performance ought to be the scope of the balance of payments problem and the progress made during the year reviewed in mastering it. The situation took a drastic turn for the worse in 1974-75, when the current deficit soared to a daunting \$3.5-4 billion. But it is not only its sheer size that is causing uneasiness; financing a deficit of such magnitude will become increasingly difficult, for it saddles the economy with a huge external indebtedness and makes it more dependent on sources that may prove unstable in the long run. The government's policy measures produced some positive results in 1975--the moderation of private consumption, reduction of the import surplus, and a slower escalation of prices--but these were by no means adequate given the dimensions of the balance of payments problem and its urgency.

The economic slowdown, reflected by the virtual flattening of domestic uses, squared with the government's objective of braking the expansion of domestic demands. This policy was dictated by the compelling need to bring the import surplus, which in 1974 hit \$3.4 billion, more in line with the prospective capital import from convenient sources in the

Table I-1
MAIN ECONOMIC INDICATORS, 1966-75^a
(percent annual increase)

| | Average 1961-65 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | | 1974 | 1975 |
|---|--------------------|-------|-------|------|-------|------|------|-------|----------------|------------------|------------------|-------------------|
| | | | | | | | | | Jan.- Sept. | Entire year | | |
| Resources and uses | | | | | | | | | | | | |
| (at constant prices) | | | | | | | | | | | | |
| Total domestic uses | 10.5 | -0.8 | 3.7 | 16.6 | 15.2 | 11.4 | 7.7 | 7.1 | 11.9 | 18.8 | 5.0 | 1.7 |
| Gross domestic product ^b | 10.0 | 1.4 | 2.5 | 14.7 | 12.9 | 8.9 | 10.2 | 12.0 | 7.0 | 6.7 | 6.7 | 1.0 |
| Gross domestic product — business sector (excl. residential rents) ^c | | | | | | | | | | | | |
| Total | 10.9 | -0.6 | 0.4 | 19.1 | 15.0 | 9.7 | 11.6 | 14.1 | 6.7 | 4.3 | 7.0 | 0.0 |
| Per employed | 6.1 | 0.7 | 6.7 | 7.5 | 10.2 | 8.1 | 6.8 | 6.4 | 1.8 | 3.4 ^d | 6.7 ^d | -1.4 ^d |
| Private consumption | | | | | | | | | | | | |
| Total | 10.3 | 3.1 | 1.5 | 11.3 | 10.5 | 3.4 | 4.9 | 9.1 | 13.6 | 9.5 | 7.5 | -0.6 |
| Per capita | 6.1 | 0.5 | -1.7 | 7.6 | 7.7 | 0.6 | 1.8 | 5.6 | 10.0 | 6.0 | 4.4 | -2.8 |
| Public consumption | 10.6 | 8.3 | 36.1 | 8.9 | 16.7 | 26.3 | 1.3 | -1.9 | -0.1 | 46.4 | 2.6 | 10.9 |
| Gross investment | 11.3 | -16.1 | -22.0 | 48.2 | 26.2 | 13.4 | 21.6 | 12.6 | 19.8 | 10.2 | 3.3 | -5.0 |
| Balance of payments,^e excl. trade with administered areas | | | | | | | | | | | | |
| (in dollars) | | | | | | | | | | | | |
| Imports | 12.0 | 3.8 | 10.6 | 24.5 | 20.8 | 21.1 | 16.3 | 5.8 | 45.1 | 63.3 | 29.6 | 12.0 |
| Exports | 15.6 | 16.6 | 6.5 | 21.7 | 11.7 | 7.6 | 33.3 | 17.4 | 32.6 | 24.7 | 30.1 | 4.2 |
| Import surplus | 8.8 | -14.4 | 18.4 | 29.0 | 35.6 | 39.7 | -1.6 | -10.7 | 68.9 | 136.0 | 29.1 | 19.9 |
| External debt | 13.7 | 7.7 | 17.9 | 22.2 | 11.7 | 23.4 | 30.8 | 19.0 | 25.1 | 24.8 | 22.7 | 21.9 |
| Foreign exchange reserves ^f | 27.7 | -3.5 | 13.7 | -7.2 | -46.0 | 6.6 | 59.2 | 86.0 | 56.0 | 58.7 | -36.9 | -2.9 |
| Population and employment | | | | | | | | | | | | |
| Average population | 3.9 | 2.6 | 3.3 | 3.4 | 2.6 | 2.8 | 3.0 | 3.3 | 3.3 | 3.3 | 3.0 | 2.3 |
| Number of Israeli employed | 4.8 | -0.6 | -4.3 | 9.0 | 3.8 | 1.8 | 3.5 | 5.0 | 3.9 | 3.9 | 0.1 | 1.2 |
| Unemployment rate (as a percent of civilian labor force) — absolute figures | 3.6 | 7.4 | 10.4 | 6.1 | 4.5 | 3.8 | 3.5 | 2.7 | 2.4 | 2.6 | 3.0 | 3.1 |

Prices and national income

(nominal)

| | | | | | | | | | | | | |
|--|------|------|------|------|------|------|------|------|------|------|------|-------------------|
| Average monthly earnings per employee posts ^a | 13.6 | 19.1 | 0.4 | 3.2 | 6.1 | 9.0 | 16.4 | 14.4 | 24.9 | 27.6 | 34.6 | 36.1 ^b |
| GNP deflator | 8.0 | 8.3 | 1.4 | 2.8 | 2.4 | 8.1 | 12.7 | 14.2 | 20.3 | 20.7 | 35.2 | 37.4 |
| Import prices ^c | 9.7 | 2.5 | 1.7 | 12.9 | 6.2 | 4.2 | 16.2 | 20.2 | 17.2 | 20.3 | 39.4 | 43.2 |
| Consumer price index (annual average) | 7.4 | 8.0 | 1.6 | 2.1 | 2.5 | 6.1 | 12.0 | 12.9 | 18.5 | 20.0 | 39.7 | 39.3 |
| National income | 18.8 | 9.0 | 4.0 | 18.7 | 15.9 | 16.4 | 24.2 | 28.6 | 28.3 | 28.2 | 42.5 | 33.6 |
| Disposable private income ^d | 18.8 | 8.3 | 7.9 | 18.9 | 15.4 | 12.6 | 25.0 | 31.4 | — | 33.0 | 46.7 | 35.4 |
| Finance (annual average) | | | | | | | | | | | | |
| Money base ^e | 18.9 | 5.1 | 22.8 | 22.6 | 4.0 | 9.0 | 34.6 | 47.5 | 21.8 | 24.0 | 5.4 | 27.0 |
| Money supply | 17.6 | 7.3 | 20.3 | 19.0 | 7.1 | 5.0 | 22.4 | 30.1 | 22.6 | 25.3 | 19.8 | 31.0 |
| Other liquid assets of the public ^f | 32.5 | 20.7 | 26.7 | 32.6 | 23.9 | 23.3 | 29.8 | 27.6 | 22.2 | 21.3 | 23.6 | 48.6 |
| Bank credit to the public and bill brokerage credit | 19.6 | 22.9 | 19.0 | 12.4 | 17.4 | 18.3 | 24.1 | 17.4 | 26.6 | 26.8 | 48.4 | 47.8 |

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

^b Valued at the effective rate of exchange.

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

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

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

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

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

^h Provisional datum, which is liable to change because of the income tax reform, which has necessitated a redefinition of wages and salaries.

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

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

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

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

coming years (as distinguished from short-term financing, or that dependent on political circumstances which are liable to change). The stagnation of the gross domestic product was a less favorable development, for it was partly due to the sagging export advance. In the short run economic retrenchment leads to the trimming of the current deficit, primarily by retarding the import of inputs, consumer products, and capital goods. In the long run the aim is to transfer factors of production to branches working for export or producing import substitutes, thereby permitting the renewal of economic growth with overseas sales moving ahead and the import surplus narrowing. Realization of this goal entails a structural change in the economy--the expanded production of export goods and import substitutes at the expense of other uses. For this purpose a change in relative prices is necessary, and in 1975 the government introduced measures aimed at making imports dearer and exports more profitable (the principal one was the initiation of creeping devaluation). But these moves proved to be of limited effectiveness, for reasons that will be discussed below.

The export targets set for 1975 were not achieved, for a number of reasons:

(a) The world economic retreat, which began in the second half of 1974, hit Israel's principal markets (this of course was a factor exogenous to the local economy).

(b) Although there was some improvement in export profitability in 1975, it was insufficient to induce a long-term structural change in the economy, and was even inadequate to counterbalance the adverse factor mentioned in (a).

(c) There was no shifting of productive factors from nonexport to export industries, and several of the latter apparently suffered from a shortage of manpower.

But even more disquieting than the slim gain recorded in industrial exports--which was also influenced by exogenous factors--was the niggardly progress made in restructuring the economy. The quite drastic steps taken, which pushed prices up sharply, produced only a modest change in relative prices and real income. This is explained by the compensatory and value-linkage devices existing in Israel, which inhibit the effort to alter the level of real income and the structure of economic activity. Also militating against this objective was the public sector's policy, which permitted the continued running of a very sizable demand surplus and a big increase in the number of public servants (including nonprofit institutions).

As stated, in the year reviewed economic activity dragged. The paltry rise in the gross domestic product and uses can be regarded, considering the possibility of estimating errors, as a total standstill. The growth rates for the year were the lowest to be recorded since the 1966-67 slump. This can be ascribed to the faltering of domestic

demand, which began in the second half of 1974 (revised national accounts data for that year show, however, that the slowdown was more moderate than originally thought). The 1.3 percent increase in the civilian labor force and that of 6-7 percent in the capital stock would have permitted a healthy domestic product gain (given the long-run uptrend in productivity, it is estimated that the product was 10 percent smaller than what could have been achieved with the factors of production available.)

The slumping of demand in the home market since mid-1974 is partly explained by the squeeze measures introduced by the government, mainly with respect to public sector investment and disposable private income. Other contributory factors have been the slower headway made by exports, due to the slackening of world commerce, and the cutting back of construction activity because of the smaller demand for homes--an outcome of the speculative accumulation of a stock of unsold units built in previous years, the slower growth of population, and the decline in real disposable income. The public sector's domestic demand as a whole did not increase in 1975, but trends here were mixed: noncivilian public consumption (excluding direct defense imports) fell off and investment by the public sector itself held steady; on the other hand, civilian consumption and public housing expanded strongly (despite the downturn in immigration). The stabilization of public sector demand should be viewed against its upsurge in the two preceding years. One manifestation of the heavier civilian public consumption was the fact that employment in this sector was not frozen (in fact, some 10,000 names were added to the payroll), while employment in the business sector turned downward. The public sector's expenditure and employment pattern has an important bearing on the economy, and modifying it is no easy task.

The influence of the government's operations on domestic demand must also be examined in the light of their effect on the demand of other sectors. First of all, it must be noted that the public sector's demand surplus--defined as the excess of domestic expenditures, including investment, over domestic revenue (taxes and transfers)--swelled from IL1.5 billion in 1972 to IL10.4 billion in 1975. In real terms the surplus trebled between 1972 and 1974 and plateaued at this high level in 1975. (Relative to the domestic product, it went up from 5 percent in 1972 to 14 percent in 1974 and 1975.) This forced the sector to resort to deficit financing, which in 1975 resulted in the pumping of more than IL5.5 billion into the economy (equivalent to almost 80 percent of the money base this year, as contrasted with a mere 16.6 percent in 1973). However, this sizable injection had only a limited impact on domestic demands, since much of it was siphoned off by private sector purchases of foreign currency. Nevertheless, there is no doubt that this

hefty injection was contrary to the government's declared balance of payments policy objectives (we shall return to this when discussing the creeping devaluation and monetary policy actions).

To complete the description of the government's influence on other sectors, mention must be made of the bulging of its transfer and subsidy payments from IL5.5 billion in 1972 to IL18.3 billion in 1975 (an average annual increase of some 50 percent). As a result, whereas the share of income from gross compulsory payments (taxes and loans) in GNP moved up from 39.2 percent in 1972 to 42.1 percent in 1975, that from net compulsory payments (i.e. after deduction of transfers) declined from 24 to 21.3 percent. It should also be noted in this context that the government has a decisive say in the provision of development credit through the financial intermediaries. In 1975 the amount of funding from this source was stepped up, and no real steps were taken to make it more expensive and hence less worthwhile.

Contrary to expectations, business investment, including that by public sector companies, did not contribute to the economic slowdown this year. Despite the buildup of spare capacity in recent years (from the beginning of 1973 to the beginning of 1975 the capital stock expanded about 25 percent, while the gross domestic product of the business sector went up only 11.5 percent). Private non-dwelling investment rose 4 percent, as opposed to 14 percent in 1974, but capital spending by public sector companies accelerated this year. The sizable investment (relative to the growth of output) was presumably influenced to a large degree by the availability of ample unlinked credit bearing a low interest compared with the rate of inflation in the last few years and that expected in the next few years.

Private consumption showed the effects of the policy of economic retrenchment. Real income per capita fell off by a rather steep 5-6 percent (if allowance is made for the abolition of compulsory loans in 1975, the deceleration was more moderate). This depressed per capita private consumption, for the first time since the 1966-67 recession, even though the decline was smaller than that in income (about 3 percent). The trend was not even during the past two years: there were sharp swings, with real income dropping because of the precipitate advance of prices in the wake of the government's policy measures (devaluations, the stiffening of indirect taxes, and the lifting of subsidies) and the previous expectation of such moves. There was an especially sharp drop of some 20 percent in sales of durables in the year reviewed. Two other developments deserve attention:

(a) Toward the end of the year consumption showed signs of perking up. This was partly due to the income tax reform, and it probably reflected a change in the public's

propensity to save (as suggested by the data on the components and level of financial saving).

(b) The drop in consumption was slower than that in income, and so the saving rate declined, for the second consecutive year.

As already pointed out, the economic slowdown was not accompanied by any substantial rise in the number of jobless (the unemployment rate drifted up from 2.6-2.7 percent in 1972-73 to 3.0-3.1 percent in 1974-75). Nevertheless, there was a definite downtrend in the labor input--the recorded number of hours worked fell off, with all the decline being in the private sector. It thus turns out that, together with the subsiding of demand for workers as the economy lost vigor, the supply of labor adjusted to the situation. (The labor input, however, trailed behind the decline in economic activity--a probable sign of hidden unemployment.) There were several factors behind the adjustment of the labor supply:

(a) The growth of the working-age population slackened because of the smaller immigration (the migration balance--the number of immigrants less the number of emigrants--fell to zero in 1975).

(b) The labor force participation rate edged down from 49.6-49.7 percent in 1972-73 to 48.3-48.5 percent in 1974-75. This occurred in the marginal age groups and among males (the female participation rate rose a notch).

(c) The number of hours worked per employed decreased (from 40 per week in the early 1970s to 38 in 1975).

(d) After rising uninterruptedly from 34,000 in 1971 to 69,000 in 1974, the number of residents from the administered areas working in Israel fell to 66,000 in 1975.

The contraction of the labor input, however, does not fully explain the paltry increase in the number of jobless. To this must be added the large number of employees taken on by the public services. (Employment in the financial services also expanded--by 7.8 percent--while that in the business sector as a whole drifted down 1 percent.) Another public sector contribution to the accommodation of the labor supply to the market situation was the much heavier payment of income supplements this year. In consequence of all these developments, the economic slowdown in 1974-75 did not result in the socio-economic distress associated with unemployment; but by the same token, while the government's policy affected the growth of the economy, it did not produce the desired structural changes in economic activity and employment. To achieve this, attention must be paid to increasing labor mobility and the provision of facilities for retraining those who will lose their jobs in branches slated to shrink.

A sectoral analysis of economic activity reveals marked disparities in 1975. Real agricultural product continued upward at a fairly vigorous pace, despite unfavorable weather conditions. Contributing to the 11 percent gain in the net agricultural product (at market prices) were the sustained rapid rise in productivity, an impressive export performance, and the much heavier sale of fruit, vegetables, and other crops on the home market (contrary to what the drop in income and the moderate growth of population would have led one to expect). Examination of the composition of agricultural production underscores the importance of the relative price factor and of the adjustment of domestic producer prices to changes in the international level. The agricultural price and subsidy policy did not result in the most efficient factor allocation, as attested by the high price paid for developing dairy farming, which is profitable for the farmer but not the national economy.

Industrial production rose only a notch (about 2 percent); after sagging noticeably in the first half of 1975, it rebounded strongly in the second half (in the final quarter it stood 6 percent above the average for the year). Production slackened in response to the changing pattern of demand for the sector's output; the weakening of private consumption demand was expected in view of the government's economic policy, and was even desirable. This was not true of exports, however. The downturn in overseas sales of manufactures (in constant price terms) was partly due to the slumping of world trade. It began in the final quarter of 1974 and continued until mid-1975, when the trend sharply reversed itself. But it seems that the turnabout in the industrial production pattern was not solely export-led, there being a revival of consumption demand in the home market as well. In the second half of 1975 industrial activity stood above its first-half level, but it is hard to say that there were distinct signs of a basic change in the structure of the sector's production or even in its overseas sales. (If fuel is excluded, industrial exports did not make further headway in the first quarter of 1976.) Such a turnaround requires the realignment of both industrial production and marketing, and there are as yet no indications that the necessary factors--the dampening of domestic consumption demand and a big improvement in export profitability--are operating with sufficient force.

The real gross product originating in transportation and communications drifted down a bit in 1975. Most subbranches recorded lower figures, with the declines being sharpest in international aviation, the pipeline transportation industry, and the ports. The dragging of activity in this sector was an outgrowth of the general economic slowdown as well as of a number of special developments this year:

- (a) The transport of defense personnel and equipment fell off (after reaching a high

level in the first part of 1974).

(b) The smaller transshipment of crude oil affected the output of both the shipping and pipeline industries.

(c) The continued skidding of tourism in the first half of 1975 and the disruption caused by the strike of El-Al workers put a damper on international aviation output.

Other service branches posted fairly small product gains in 1975, although developments in the public services were not favorable, as explained above. (The growth of civilian public consumption and personnel, as well as the increase in the number of employees in the financial services, did not further the required restructuring of the economy.)

The government's policy measures and their repercussions on the level of economic activity must also be judged in relation to the movement of prices. In 1974-75 prices shot up, and this period can be called one of high inflation. The advance slowed conspicuously in the year reviewed, even though there was not a big difference in the annual average increases. In 1975 the consumer price index went up 23.5 percent, as contrasted with 56.2 percent in 1974, when most of the rise occurred after the November policy moves; on an annual average, the increases were 39.3 percent in 1975 and 39.7 percent in 1974. The upward thrust on prices in the last two years came mostly from the costs side, in contrast to earlier years, when inflation was chiefly of the demand-pull variety. The government's measures, as mentioned, were designed to change relative prices (through devaluations) and to draw out purchasing power (through indirect taxes and the elimination of subsidies), But these steps proved to be only slightly successful, mainly because of inflation-proofing. There is no reason to compensate the public for the measures designed to depress real income or for price increases connected with the dearer imports policy; it is enough to see to it that no undesirable changes take place in the distribution of national income.

Import and export prices outpaced the GNP and domestic use deflators (up 42.5-45 percent vs. 37.5-40 percent respectively); in other words, relative prices changed in the right direction. But this fairly small change in relative prices cost the economy dearly in terms of high inflation. It would be worthwhile investigating if this objective could be achieved without such a strong inflation. The socio-economic price to be paid for modifying the practice of value-linkage and wage indexation may be lower than that exacted by inflation such as that which prevailed in this country in 1974-75.

Money and capital market developments in the year surveyed should be examined in the light of their effect on real (i.e. nonfinancial) economic activity and the interrelations between them and the financing of the public sector, the level of saving, and the balance

of payments position.

As regards the monetary situation, the year reviewed saw a hefty liquidity injection by the public sector, but most of it was drawn out by foreign currency purchases of the private sector. The IL5.5 billion pumped in by the public sector indicates that its domestic outlays (including credit granted) far surpassed its domestic revenue (including credit from the public). To prevent such a massive injection, the sector should have pruned its payments (consumption, investment, and lending) or stepped up its receipts (taxes and borrowing from the public). In addition to the amount put into the economy by the public sector, the Bank of Israel was responsible for IL1.5 billion, most of it through the directed credit funds.

The financing of exports, which serves a top-priority economic objective, has come to have serious side-effects on monetary developments. Because of the low price of such funding, it is in heavy demand, and the readiness of the commercial banks to meet it has grown with the reduction of their participation in the directed credit funds from their own means; this has had an expansionary impact on the monetary aggregates. The granting of export finance in foreign currency alone would probably diminish the liquidity injection without seriously affecting the availability of credit. The problem of export profitability should be tackled separately, and not by giving exporters a subsidy that increases with the amount of credit they receive.

The liquidity injection by the public sector and Bank of Israel, which was equal to the money base (narrowly defined) at the beginning of 1975, did not fuel a livelier domestic demand, because of the large-scale foreign exchange purchases by the private sector (although it probably headed off a further contraction of business sector activity). Part of the IL6.5 billion of foreign currency acquired was used to finance the private sector's structural balance of payments deficit, but another part was almost certainly used to reshuffle the sector's asset portfolio-- primarily by business enterprises, in response to the policy of mini-devaluations and the persistent expectation of larger devaluations. If the foreign currency purchases are discounted, the growth of the money base was quite small (about IL500 million), but to complete the picture it must be added that the banks' liquidity shortfalls rose from their already fairly high average level of 1974 (IL480 million) to a formidable IL700 million annual average in 1975. This was a very disturbing development, as it severely inhibited the various monetary measures adopted.

The growth of the banks' liquidity deficiencies stemmed from the expansion of ordinary credit in Israeli currency. Total IL bank credit (ordinary and directed) was 34 percent up from its average level in 1974. True, prices jumped 40 percent on an annual average in

1975, but the banks supplied 39 percent more foreign currency credit in dollar terms, which constituted a big real increase. It therefore turned out that, even though money became a little tighter in 1975, as reflected by the steep rise in debitory interest rates, there was no reason to loosen the reins by permitting a larger expansion of bank credit. (The raising of interest rates was consistent with the policy of economic retrenchment; another factor pushing them up was the mini-devaluations.) A policy of monetary restraint was imperative because bank credit, along with other components of the liquidity injection, stoked demand for foreign currency for the purchase (by firms and households alike) of imported assets, as well as for building up stocks, advancing purchases abroad, repaying debts, and investing in financial assets. While it is hard to say with any degree of certainty whether a larger absorption by the Bank of Israel would have dampened purchases of foreign currency, or whether it would have hurt real economic activity, it seems that, given the country's balance of payments position and the economic policy objectives as a whole, there was room for trying to reduce the monetary injection even if it would have adversely affected domestic economic activity.

During a period of high inflation the public's desire to hold unlinked financial assets fades. In 1975 the money supply was 31 percent above its nominal annual average level the year before. The real decline in this monetary aggregate, for the second year running, was reflected by a further rise in its circulation velocity. As to other financial assets, the real decrease in ordinary time deposits and the Short-Term Loan, which are not value-linked, is understandable. But it is of interest to note that even linked Israeli currency assets grew more slowly than in 1974. Sales of linked IL-denominated bonds by the government and others, less principal, linkage, and interest payments, totaled IL4.2 billion--up 18 percent, as opposed to a rise of 32 percent in 1974 and more than 100 percent in 1973. (In constant price terms the slowdown was more pronounced.)

The figures on bond sales are not a direct reflection of household behavior, for a large percentage of the securities are purchased by social insurance funds, insurance companies, mutual funds, and bank-administered savings schemes. Examination of the change in their holdings of household savings--less withdrawals of principal, interest, and linkage increments, as well as their purchases of bonds from households--reveals an interesting development: in 1975 such deposits added up to IL5.6 billion, 42 percent more than in the previous year. While this rate was about the same as in 1974 (45 percent), there was a significant change in the course of the year reviewed: in the first half growth amounted to IL3 billion net, but in the second half it came to only IL2.6 billion--a decrease of 14 percent in nominal and 22 percent in real terms in the rate of

accumulation. In the last six months of the year two significant developments took place:

(a) Financial saving in the form of bonds and through thrift institutions fell off conspicuously. It will be recalled that the second half of the year witnessed a rise in income (due *inter alia* to the income tax reform and a sizable compulsory loan redemption), and the public apparently used the extra money for buying consumer goods and other assets.

(b) The public was inclined to reshuffle its assets portfolio. The heavy demand for foreign currency points to the direction of one change: Another took place in the composition of institutional saving: along with the contraction of savings scheme deposits and bond purchases, there was a heavy investment in mutual funds, chiefly those placing part of their resources in foreign currency assets.

It should be stressed that these developments occurred before the capital market changes announced in the middle of December, whose unsettling effects began to appear in 1976. While it is still too early to summarize their repercussions, it is abundantly clear that they have further discouraged the public from investing directly in bonds, and perhaps also in other financial instruments.

The amount of long-term credit supplied by financial intermediaries totaled IL6.8 billion, 44 percent more than the year before. Fixed investment (nondwelling and housing alike) expanded in 1975 by 26 percent at current prices. The amount lent to households, mostly for buying homes, rose at a comparatively sluggish rate (24 percent, to IL2.4 billion), due to the softening of the housing market. On the other hand, credit to other sectors of the economy was stepped up greatly. Industry, agriculture, construction, and the services received IL3.6 billion all told-- 72 percent more than in 1974.

The rate of investment financing, i.e. the ratio between total loans granted and the total value of investment, went up in all sectors. Most of this funding is provided by the public sector on unlinked, low-interest terms. Obviously at a time of inflation it is in heavy demand, and the public sector thus stimulates the expansion of investment when there is already plenty of spare capacity.

Another noteworthy phenomenon is that in neutralizing the influence of the interest rate in the capital market (the reference is to the big differential between the rate paid on the funds mobilized in the market and that charged borrowers), the link was also severed between the sums raised by the government and other capital market issuers on the one hand and the volume of directed credit made available to households and business on the other. In the second half of 1975 the amount of funds procured fell off, but the credit outflow continued to expand, for the loan commitments were not made contingent on the prospects of raising capital. Part of the government's liquidity injection and the

banks' liquidity deficiency in the second half of 1975 may have been connected with the need to substitute for loanable funds that could not be obtained in the capital market.

If the monetary and capital market developments are viewed in conjunction with the data pointing to a drop in the saving rate in 1974 and 1975, it is clear that the guiding principle in reforming the capital market must be an attempt to maintain a relatively high rate of financial saving while eliminating to the greatest degree possible the distortions in the present system. In this connection the following points deserve attention:

(a) The expectation of real devaluations (i.e. by more than the rate of inflation), which the balance of payments position would seem to dictate, enhances the attraction of foreign currency assets and those linked to the exchange rate. As long as this situation persists, the authorities should consider the introduction of suitable financial assets that do not involve any loss of foreign exchange reserves.

(b) When inflation is running at a high rate like that in 1974-75, the supplying of credit at interest rates amounting to no more than a quarter or a third of the percentage rise in consumer prices creates socio-economic distortions. It results in an inefficient allocation of credit, widens the disparity between the worthwhileness of an investment to the investor and that to the economy, and gives the borrower a big subsidy from the public purse. This goes for directed bank credit, whose growth has posed a serious monetary problem, as well as for unlinked development loans (which throw an unforeseeable and uncontrollable burden on the government budget).

(c) In the long run financial saving must be based on the slowing of the price advance, with indexation serving to cushion shocks but not being the cornerstone of the system. It is fallacious to think that the value-linkage device--in particular the unsymmetrical, distorting arrangements presently in force--blunts the damaging effects of inflation. This makes it necessary to draw up a policy designed to bring about the required alteration of relative prices with the lowest possible advance in the general price level.

In summary, the economy's performance in 1975 must be measured, as mentioned, by the degree of progress made in solving its paramount problem--the balance of payments. Since the solution of this problem is the cardinal objective of economic policy, it follows that the balance of payments test is also the test of the country's economic policy.

The aggravation of the country's balance of payments situation since the Yom Kippur War is seen in the fact that the current deficit has reached such proportions that it can no longer be financed for very long. After standing at \$1.2 billion in each of the years between 1970 and 1972, the deficit jumped to \$3.4 billion in 1974 and hit \$4 billion in 1975. (Net of defense imports, it rose from \$600-700 million per annum in the early 1970s

to \$2.2 billion in 1974 and 1975.) Excluding unrequited receipts, the amount from other sources available for financing the deficit shot up from approximately \$500 million in the early 1970s to an average of \$2 billion in 1974-75. Part of the deficit has stemmed from the mounting defense import bill, which at present is overwhelmingly financed with U.S. government aid, but in 1974-75 the economy was unable to even cover the civilian deficit from convenient sources which presumably will not dry up in the years ahead. The consequence has been a bulging of the economy's foreign currency indebtedness, which at the end of 1975 reached a staggering \$7.6 billion. In the last three years these debts have risen by \$1 billion a year, with the figure for 1975 being \$1.4 billion. Moreover, in the last two years the economy has had to resort to more short-term financing, with the result that short-term foreign indebtedness rocketed from \$190 million at the end of 1973 to over \$900 million two years later (this was also reflected in the running down of the net foreign exchange holdings of the banking system).

In the interim period, during which steps must be taken to whittle down the current deficit, it is extremely important to raise funds in order to avoid a financing crisis. But the paramount problem is to retard the growth of imports, and even more, to expand exports. The period of grace which the economy has to take the necessary action to master the underlying problem is not long, considering the constraints imposed by the swelling external debt and its composition.

In 1975 the import bill was up 5 percent at constant prices, but the more than 35 percent larger real defense import goes far to explain this increase. If direct defense imports and the ships and aircraft item are excluded, there was a real drop of 1 percent in total imports and 6 percent in commodities. This downswing was to be expected in view of the economic slowdown and the higher relative price of imports this year. In fact, an even more pronounced contraction seemed likely, but the persistence of devaluation expectations induced a further buildup of stocks, a trend begun at the end of 1973.

Once the economy resumes its growth, the chances of reducing imports will be quite slim, so that most of the burden of trimming the deficit will fall on exports. In this respect 1975 was a disappointing year, for overseas sales moved up only 3 percent overall in constant price terms; this fell short of the long-run trend, and even more important, of what was required to alleviate the balance of payments strain. To be sure, farm exports moved ahead by an impressive 23 percent in quantitative terms, but industrial sales (excluding minerals and diamonds, which are subject to special factors) failed to make any progress whatsoever. In this context two points should be observed:

(a) The world economic slump in the first half of 1975 partly explains the sagging of

industrial exports from the final quarter of 1974 to the middle of 1975.

(b) The rebounding of such sales in the second half of 1975, and particularly in the fourth quarter, was due to the revival of foreign demand, but it is too early to judge the strength and durability of the upward trend.

The industrial export picture in 1975 might have been less worrisome had there been any definite signs of the creation of such conditions as would ensure a strong takeoff and continuation of the upward thrust of overseas sales after the recovery of Israel's foreign markets. These prerequisites are a drastic change in export profitability and the restructuring of production and employment. The indicators of industrial export profitability show a modest improvement in the year reviewed compared with 1974, but instead of the curve continuing upward in the course of 1975, the opposite was true. There seems to be some reluctance to bring about a marked improvement in export profitability for fear that in the short run this will not prove an effective stimulant. This argument cannot be dismissed outright, but it would seem that the restructuring of the economy in the long run entails a much higher export profitability, so that those planning to step up their overseas marketing can better size up their prospects and marshal the necessary factors of production, including skilled labor. It should be stressed that an advance of 5 percent, for example, in the price received by the exporter relative to what he pays for his inputs has a completely different meaning during a period of price stability than one of rampant inflation, when the gain is liable to be erased within a few weeks.

At the same time care must be taken not to boost export profitability in a way that will indirectly harm the economy, such as an unrestrained increase in directed export credit granted unlinked and at an extremely low rate of interest.

Besides the export profitability factor, it is important to leash domestic demands, so that nonexport branches, notably the public services, will be unable to continue expanding and adding to their payroll workers needed by the export enterprises. Boosting the export share of resource use necessitates reducing the share of domestic demands, which are directly and indirectly susceptible to government influence. The volume and composition of public sector spending determines the behavior of other sectors of the economy, and hence the pruning of such expenditure is essential.

The restructuring of the economy is a painful but necessary process, entailing a reexamination of those institutions and practices that have rendered the economy's adjustment apparatus less flexible. The gravity of the balance of payments situation makes it imperative to carry out such a reexamination and to grapple with the problem of restructuring the economy without further delay.