7

THE BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

A deficit of about $200 million in the external current account was recorded in 1988, equivalent to half a percent of GNP (see Table 7.1).[1] The favorable state of the current account—one of the main achievements of the 1985 stabilization program—was maintained in the year under review, although there were sharp changes in its various components. These reflected a slowdown in the country's foreign trade that was more pronounced than the slackening of overall economic activity.

The volume of total trade in goods and services (excluding capital services and direct defense imports), which in 1987 had expanded by 11 percent, shrank this year. Exports contracted by more than 2 percent while the volume of imports remained unchanged, increasing the import surplus by volume. However, the changes in dollar prices reduced the import surplus in value; dollar prices of Israeli exports rose by 12 percent, while import prices increased by only 7 percent. This improvement in the terms of trade (following a 3 percent deterioration the year before) brought a gain of more than $500 million which offset the contraction of the export volume and the rise in net interest payments to the rest of the world. In sum, the civilian import surplus decreased this year by some $100 million.

The trade figures (including trade between Israel and Judea-Samaria and Gaza) show the impact of the uprising in the territories which began in late 1987. But even after deducting its effects, which are estimated below, the data show only a modest 2 percent increase in the volume of exports and imports, with the gap between them remaining at last year's level.

[1] Israel's defense imports fluctuate sharply from year to year, while expenditure and the defense aid financing them are more even over the years. For the purpose of analysis it is preferable to substitute data on annual expenditure for the data on defense imports, since in some years the former includes advances paid for future defense imports, while in other years past advances are used for current imports. The current account, 'adjusted' for these advances, is shown in Table 7.1.

TABLE 7.1

Balance of Payments Indicators, 1977–88

	1977–1981	1982–1983	1984	1985	1986	1987	1988
$ billion current prices							
Total current account	–0.7	–2.0	–1.4	1.1	1.6	–1.0	–0.7
'Adjusted' current account[a]	–0.8	–2.1	–1..6	1.1	0.9	–0.2	–0.2
Total import surplus	3.3	4.6	4.7	3.8	3.8	5.8	5.3
Civilian import surplus[b]	1.8	3.3	3.2	2.0	2.6	3.3	3.2
Civilian, excl. capital services	1.2	2.4	1.5	0.3	1.0	1.8	1.6
Unilateral transfer, public sector, net	1.6	1.7	2.5	4.2	4.2	3.3	3.2
Unilateral transfer, private sector, net	1.1	0.9	0.8	0.8	1.2	1.6	1.5
Derived private capital imports[c]			–0.3	–0.9	–0.0	0.8	–1.6
Net foreign debt	12.6	16.2	18.9	18.6	18.3	18.3	18.6
Gross foreign debt	18.9	28.2	29.5	29.5	30.8	31.9	31.1
Foreign reserves[d]	3.3	4.0	3.3	3.8	4.9	6.0	4.8
Quantity changes, percent							
Exports, excl. capital services	6.2	–0.5	13.5	7.6	4.9	10.7	–2.3
Civilian imports, excl. capital services	7.0	10.9	–2.4	–4.3	13.8	12.3	–0.2
World trade	3.6	0.4	8.8	3.1	4.4	6.1	9.3
Exchange rates, Ratios and indexes (1980=100)							
Sheqel exchange rate against the dollar	0.004	0.04	0.29	1.18	1.49	1.59	1.60
Sheqel exchange rate/5-currency basket	0.005	0.04	0.26	1.07	1.47	1.68	1.72
Net foreign debt/GNP, percent	61	64	77	81	65	55	46
Net foreign debt/exports, percent	130	160	180	170	156	132	123
Import prices/domestic use prices,[e] index	105	87	86	93	81	79	74
Export prices/domestic use prices,[e] index	107	92	91	91	80	76	74
Terms of trade, excl. capital services,[f] index	104	109	107	107	110	107	112

[a] Adjusted for advances on defense imports; see note a to text.

[b] Excluding direct defense imports.

[c] See Table 7.A–4.

[d] Held by central monetary authorities.

[e] Relative to domestic use of resources. Calculated from national accounts indexes of import and export prices and price index of domestic use of resources. Excludes direct defense imports.

[f] Civilian imports and exports, excl. capital services.

These developments were accompanied by the continued real appreciation of the currency in all its varied manifestations. Local prices rose faster than in Israel's trading partner countries, despite the fact that the exchange rate against the currency basket remained unchanged until the end of 1988; the domestic product rose more rapidly in price than foreign trade prices; and (particularly) wage costs per unit of output continued to mount, albeit more slowly—especially in the tradeables sector—as the year went on.[2]

[2] The sector producing goods actually traded internationally and those of similar type.

The real appreciation of the currency[3] is at least partly the consequence of using a stable exchange rate as the principal anchor of stability. This imposed tighter constraints on price rises in the tradables sector as compared with the nontradables sector, with the result that prices in the former rose less than in the latter. The real exchange rate was thus eroded (see Chapter 3). However, this disparity of price movements found almost no reflection in differences of wage increases in the two sectors; unit wage costs thus rose faster in the tradables sector than in the nontradables sector (see also Chapter 4). This differential development may explain the more pronounced slowdown exhibited by the foreign trade data. Moreover, some adjustment of the exchange rate was apparently taken into account in the wage bargaining process; in consequence, the postponement of devaluation to the end of the year contributed to accelerating the real appreciation. But the slowdown of exports cannot be attributed wholly to the delay in devaluing the currency. Developments in this respect over several years were more complex. The previous year's accelerated growth of economic activity also showed up markedly in the foreign trade data, although it was similarly accompanied by a real appreciation. This calls for examining developments in a broader context of internal and external changes that have taken place.

The slow convergence of price and wage rises, important in itself, also illustrates that a long time may elapse until the economy adjusts to conditions of a lower inflation rate. In other areas, as well (production for exports, as well as for the domestic market) it seems that a long time was needed to adjust to the post-stabilization economic environment (see Chapters 1 and 6). Moreover, examination of the business state of firms and sectors which had run into financial difficulties in the previous two years shows clearly that these new conditions also raised the need to solve problems originating in earlier years. Part of the explanation for the postponement of solutions for these structural problems (such as over-investment and continued operation in the face of losses) is apparently to be found in the inflationary environment and a certain belief that government assistance would be forthcoming in crisis times. But most of the changes in economic policy were oriented towards eliminating distortions and are bound to achieve a better functioning of the economy after a temporary slowdown in the adjustment period. The first fruits of such an

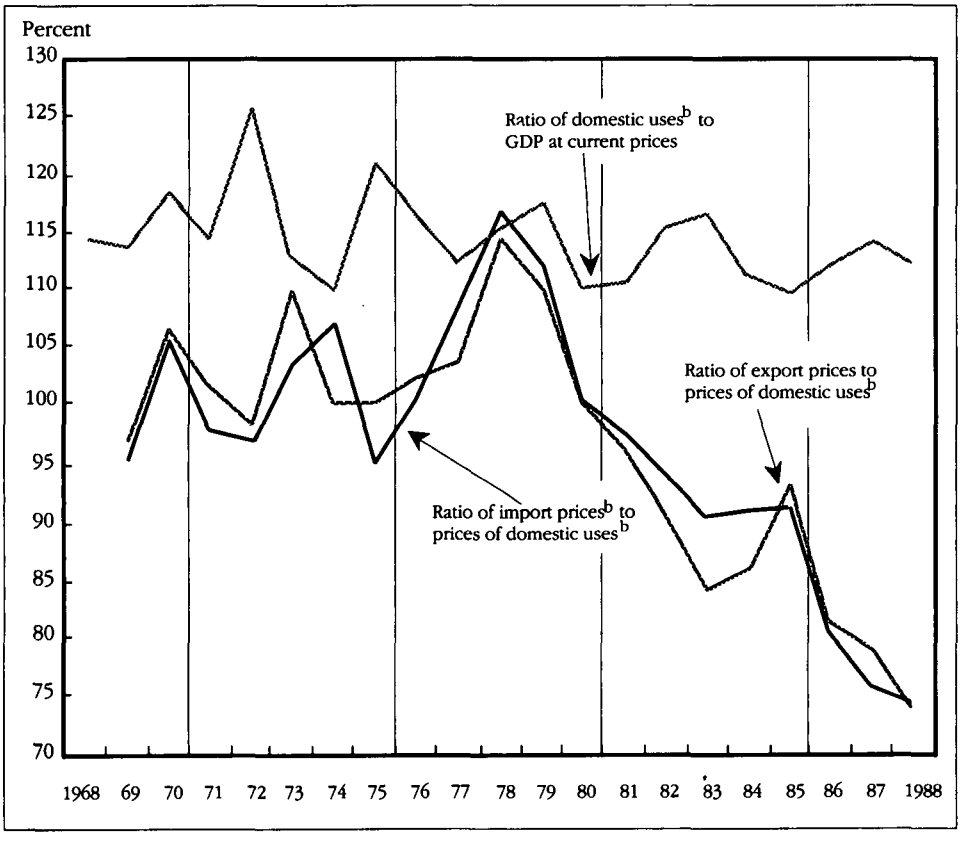
[3] The Israeli economy has experienced a trend of real appreciation ever since the end of the 1970s (see Fig. 7.1). This trend was interrupted in 1984 and 1985, and resumed its course after the stabilization program. For a detailed analysis of the possible implications of this trend, see Bank of Israel Annual Report 1978, pp. 106-107.

improved functioning explain, among other things, the previous year's acceleration of economic activity, mainly for exports. In contrast, the salient feature of 1988 was the slowdown that accompanied the adjustment process and structural change.

The foregoing discussion does not provide a full explanation of the magnitude of the changes that have taken place in the last few years, and of the timing of the changes of trend in economic activity and foreign trade. The difficulty in explaining the macro-economic development may lie in the very changes in behavior patterns and the diverse pace at which firms adjusted to the new conditions at home and in world markets (particularly to the great change in the exchange rate of the dollar against European currencies). Firms

Figure 7.1

Domestic Uses, Gross Domestic Product[a] and Relative Prices, 1968–88



[a] Until 1979, calculated according to the old system of national accounts; from 1980—in accordance with the new SNA.

[b] Excluding direct defense imports.

SOURCE: Table 7.1 and Chapter 2.

reacted in accordance with the specific circumstances in which they operated and with the flexibility they were able to muster. The economy did not, therefore, function in accordance with established response patterns. In this period of transition it was difficult to foresee the trends of overall economic activity and their reflection in foreign trade. Nor is it easier now, with the benefit of hindsight, to offer a full explanation for them.

Given the favorable state of the current account, the magnitude of the capital movements induced by cycles of devaluation expectations is remarkable. The large-scale capital exports in the last quarter of the year—$1.8 billion—reflect the certainty with which the public expected a devaluation. After the 5 percent devaluation in the last week of 1988 and another 8 percent devaluation in early January 1989, the public reacted by importing capital in an amount which, by the end of the first quarter of 1989, equalled the capital exports prior to the devaluation.

In addition to the speculative cycle, two non-recurring events were prominent this year in the capital account. The first was that part of the debt to the United States—about $4.8 billion—was converted by the flotation on the U.S. capital market of bonds carrying an almost full guarantee by the U.S. government. This conversion made no change in the size of the debt; its sole purpose was to reduce Israel's interest burden in future years. The interest on these bonds is substantially lower than that on the original U.S. loans, which was set at the going market rate at the time when these loans were granted.

The second extraordinary event was the redemption of $800 million in bank shares held by nonresidents, under the "bank share arrangement". Under the rules by which the statistics of the foreign debt and the balance of payments are compiled, the whole of this redemption was recorded as a repatriation of investment to the rest of the world—as an addition to the net foreign debt this year, despite its being a liability created in 1983. The actual redemption is carried out by the banking system, which disburses the amounts due to the foreign owners in instalments over several years. That gradual disbursal means that annual redemption payments have only a small impact on the foreign reserves.

The net foreign debt increased in 1988 by about $350 million, to a total of $18.6 billion—equivalent to 46 percent of the GNP. The rise in the net foreign debt was the result of a decline in the gross debt and a steeper fall in foreign currency reserves, which contracted by $1.2 billion. By the end of the year, they were equivalent to less than three months' worth of imports—as against reserves of 3.7 months of imports at the end of 1987. However, the level of the

end-of-year reserves and foreign debt represent a low point related to the speculative cycle. As stated previously, the accumulation of foreign reserves was resumed following the devaluation, and by the end of the first quarter of 1989 they returned to a level equal to 3.7 months of imports.

Partial data for the first four months of 1989 point to stability, and even some decline, in the components of merchandise trade relative to the corresponding period in 1987. These data therefore do not indicate a change in economic trends.

* * *

The year's contraction in the volume of exports and the halt in the increase of import volume came after several years of rapid expansion in the country's foreign trade.[4] Despite their substantial magnitude, the implications of the uprising in Judea-Samaria and Gaza that began at the end of 1987 only partially explain this change of trend. The decrease in exports to Judea-Samaria and Gaza is estimated at some 35 percent, and imports from there fell by about 31 percent (see Table 7.5). According to past experience the steep drop—some 12 percent—in exports of the tourism industry can also be attributed mainly to the unrest in the region. The fall in exports to Judea-Samaria and Gaza, together with the decline in tourism, is equivalent to 4.2 percent of the total 1987 export volume (see Table 7.2), while the contraction of imports from the territories was equal to some 2 percent of last year's total import volume. The contribution of these items can serve as a rough approximation of the overall impact of the events in the territories on the import surplus. There were, of course, other influences, reflected in other items; furthermore, possibly not all the deterioration in the items discussed here can be ascribed to the unrest in the territories. If they are nevertheless taken as an approximation, and the decline in these three items is deducted from the overall export and import data (i.e., assuming they had remained at last year's level), the result is a 2 percent increase in export volume as against the actual contraction of 2.3 percent, and a 1.8 percent rise in the volume of civilian imports instead of the actual decline of 0.2 percent. In terms of current dollar value, these three items reduced the decline in the import surplus by $140 million.

[4] In the present discussion exports and imports exclude capital services and direct defense imports.

TABLE 7.2

Sources of the Change in the Volume of Exports, 1976–88

(Percent, excludes capital services)

					Deviation from trend[a]		
	1976–85	1986	1987	1988	1986	1987	1988
Total change in export volume	6.6	4.9	10.7	–2.3	–1.7	4.1	–8.9
Contribution of:							
Diamond industry	0.0	3.3	3.2	0.4	3.3	3.2	0.4
Other exports, excl. diamonds	6.6	1.6	7.5	–2.7	–5.0	0.9	–9.3
Exports to JSG and tourism[b]	1.0	–1.5	2.2	–4.2	–2.5	1.2	–5.2
Other exports	5.6	3.1	5.3	1.5	–2.5	–0.3	–4.1
of which:							
Industrial exports excl. diamonds	4.0	2.6	3.9	1.6	–1.4	–0.1	–2.4
Agricultural exports	0.3	0.6	–0.4	–0.8	0.3	–0.7	–1.1
Services exports, excl. capital services and tourism	1.3	–0.1	1.8	0.7	–1.4	0.5	–0.6

[a] The difference between the annual percentage change and the average rate of change between 1976 and 1985.

[b] The quantitative change in tourism for 1976–80 was estimated according to tourist arrivals. From 1981, the estimate is taken from the national accounts.

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

However, developments in exports are only partially explained by the events in the territories, the halt in the growth of diamond exports (in which ups and downs have been experienced in the past) and by the steep fall in agricultural exports (which are subject to the vagaries of nature and affected by policy changes). The main puzzlement is over the small 3.9 percent increase in industrial exports (excluding diamonds), which had grown annually at twice this rate (7.7 percent) over the three preceding years, and in view of an annual growth of some 12 percent from the mid-1970s until 1984. For many years these exports accounted for some 60 percent of total export growth (albeit with annual fluctuations; see Table 7.2).

Industrial exports and the factors affecting them are discussed in detail in section 2.b below, and the main points will be recapitulated here. World demand, as represented by the volume of international trade, has expanded in recent years and at a much accelerated pace in the year under review, (see Table 7.1). The growth of domestic demand, on the other hand, slowed considerably this year, after two years of rapid expansion. This should have led to accelerated export growth in 1988, especially in view of the marked response, in past years, of the volume of exports to an expansion in world trade. However, this

year's development in industrial exports[5] took a different turn: having grown by 5.7 percent in 1986 and 9.3 percent in 1987, they rose by only 3.9 percent in 1988. The reasons for this tapering off of export growth must therefore be sought on the supply side.

An examination of the indexes of real wages in this and other chapters of this report (Chapters 4 and 6) indicates that there has been a substantial and steady rise in wage costs since 1985. Especially striking, in view of the stability of the exchange rate, is the increase in wage costs in the tradables sector. A continued slowing of the rate of export growth would have been consistent with the rise in wage costs. But (as stated before) exports expanded in 1987 at an accelerated rate.

An examination of exports by geographical destination raises another possibility: in 1986 and 1987, exports to Europe benefited from a substantial nominal depreciation of the sheqel against the European currencies (which had strengthened against the dollar). In 1988 this depreciation was halted. At the same time, exports to the dollar bloc were faced by a nearly fixed nominal exchange rate. The great changes in the cross rates of foreign currencies, combined with the greater sensitivity of export to Europe to the sheqel exchange rate, perhaps explain the temporary 1987 increase in overall exports. Partial support for this hypothesis is provided by the data on exports by branches.

In addition to the specific export-related explanations suggested above, and some others that will be mentioned further on, it seems that some factors behind the 1988 recession and some causes of the 1987 expansion of economic activity were common to exporting firms and others, especially—but not exclusively—in industry. In industry, this is evidenced by the slackening of overall output, following its rapid expansion in the two preceding years. The slack was at least as great as that recorded for industrial exports. In 1986 and 1987, industrial production rose by an annual average of 4.3 percent; in 1988 it contracted by 3.1 percent. (If exports to Judea-Samaria and Gaza are excluded—by about 2 percent.)

Exports have slowed relative to the past, but not relative to industrial output as a whole. In the final account, they increased their share in total industrial production. Therefore it is possible that the specially acute difficulties confronting exports, such as wage costs, were accompanied by supporting factors, such as the growth of international trade and easier credit conditions. Consequently, the causes of slower export growth should be sought in the factors affecting overall industrial production.

[5] Industrial exports here do not include exports to Judea-Samaria and Gaza.

The principal message of the 1985 stabilization program to the producing sectors was a change of emphases: much greater stress on economic efficiency and decisions on production and a lesser role of financial management and reliance on current government support and backing at times of crisis. The government's conduct until the end of 1988, and its adherence to its objectives, gradually enhanced the credibility of this message. The lowering of inflation was crucially important for shifting the emphasis, at the enterprise level, to productive activity, and releasing resources for this purpose at the expense of financial activity. The rapid growth of economic activity in 1986 and 1987 may have been the first result of lower inflation, expressing itself in a large rise in domestic demand (in addition to more favorable conditions for exports to Europe) together with high productivity growth, especially in 1987. The latter made it possible to both accommodate the higher domestic demand and increase the volume of exports. The productivity growth of these years occurred not only in growing industries, but also where industries which were forced to contract raised their efficiency. Already in 1988, there were signs of recovery in some industries. Still, the overall picture for 1988 was that of an adjustment process in full force, as the expansion of domestic demand tapered off, conditions for exports to Europe worsened, and the government persisted in its stabilization policy.

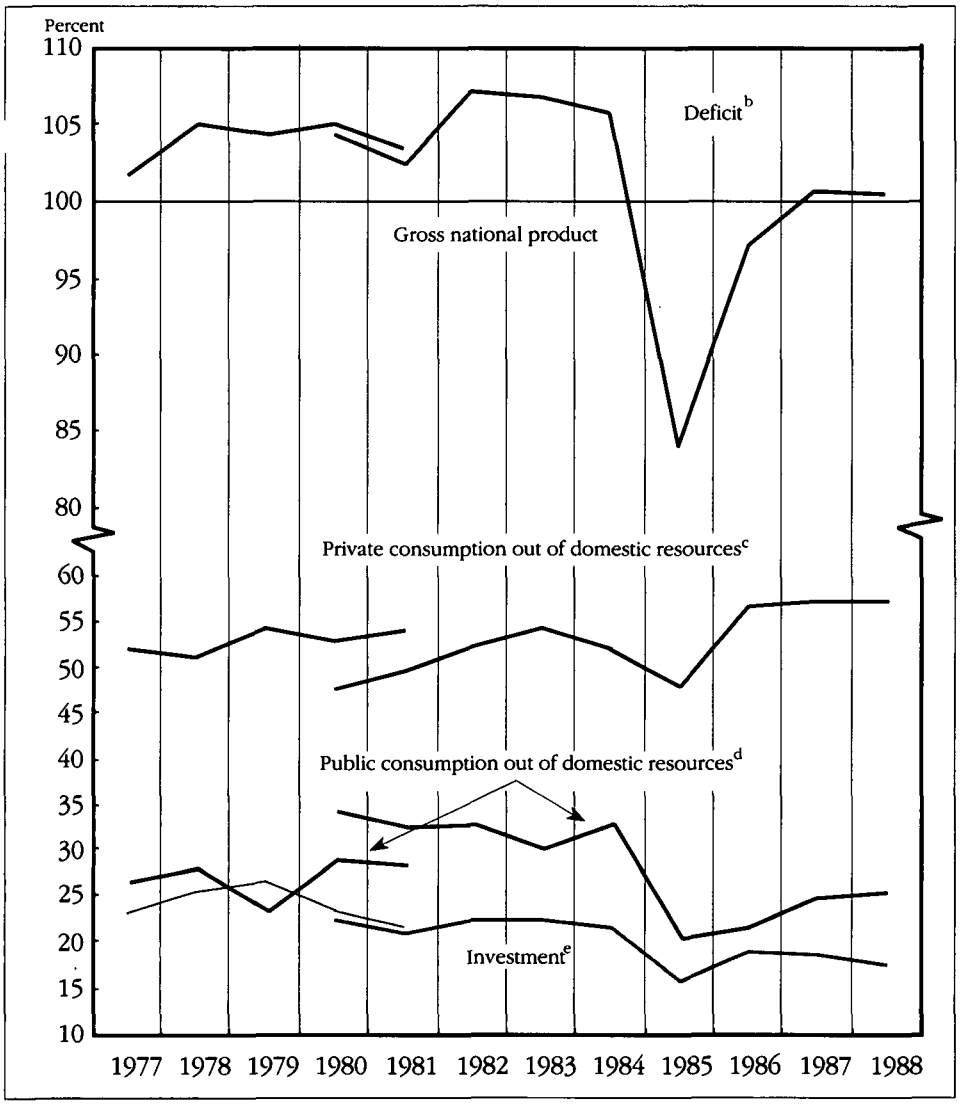
Similar patterns of accelerated economic activity and subsequent slowdown have been experienced by other economies where stabilization programs were launched from high levels of inflation. In most cases, the recession phase generated a crisis of confidence which in turn led to balance of payments crises, more frequent and higher devaluations, and a renewed outbreak of inflation. In Israel, by contrast, it appears that the government and the stable exchange rate regime gathered increasing credibility as time went on. Some evidence for this with respect to the balance of payments is to be found in the following:

a) In 1984 and 1985, the private sector's unilateral transfers from abroad fell to a low level. This was an expression of apprehensions that financial assets might be taxed, and fear that the government might not honor its obligations (see Table 7.6). After the stabilization program, there was a rapid recovery in these transfers, which reached a peak in 1987. A slight decline was recorded in 1988, but unilateral transfers still stand at a level twice as high as in the years of their nadir. The moderate decline of unilateral transfers, despite the large scale of the year's speculative capital exports, may testify to the low probability which individuals accord to the occurrence of a crisis.

Figure 7.2

Total National Expenditure by Components and the 'Adjusted' Current Account Deficit, 1977–88[a]

(Percent of gross national product, at the official exchange rate)



Definitions:

[a] The break in the series is due to the use of the old SNA until 1981; the new SNA is from the end of 1980.

[b] The 'adjusted' current account deficit is calculated at the official exchange rate.

[c] Private consumption less private sector net unilateral transfers from abroad.

[d] Total public consumption, less public sector net unilateral transfers from abroad, adjusted for advances on defense imports.

[e] Gross capital formation and change in stocks.

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

TABLE 7.3
Goods and Services Account, 1985–88[a]

	$ million				Percent annual change					
					Price			Quantity		
	1985	1986	1987	1988	1986	1987	1988	1986	1987	1988
Imports										
Goods, excl. fuel and diamonds[b]	4,971	6,385	7,992	8,370	9.0	9.8	9.5	17.9	14.0	–4.4
Fuel	1,510	924	1.148	1,062	–46.0	22.0	–20.4	13.3	1.8	16.2
Diamonds	1,168	1,598	1,901	2,429	10.0	3.5	19.5	24.3	14.9	6.9
Services, excl. capital services[b]	2,406	2,616	3,172	3,550	7.0	9.7	1.9	1.6	10.5	9.8
From Judea-Samaria and Gaza	482	727	973	827	37.8	20.5	23.9	9.4	11.1	–31.4
Civilian imports, excl. capital services	**10,537**	**12,250**	**15,185**	**16,238**	2.1	10.4	7.1	13.8	12.3	–0.2
Capital services	2,702	2,501	2,438	2,637						
Direct defense imports	1,852	1,202	2,472	2,106						
Total imports	**15,092**	**15,954**	**20,095**	**20,982**						
Exports										
Goods, excl. diamonds[b]	4,739	5,211	6,078	6,816	2.8	8.5	10.3	7.0	7.5	1.7
Diamonds	1,263	1,664	2,059	2,547	3.9	1.4	20.9	26.8	22.0	2.3
Services, excl. capital services[b]	3,471	3,430	4,141	4,455	7.3	8.5	9.1	–7.9	11.3	–1.4
To Judea-Samaria and Gaza	733	970	1,148	869	15.7	10.9	16.8	14.3	6.7	–35.2
Subtotal	**10,206**	**11,276**	**13,426**	**14,687**	5.3	7.6	12.0	4.9	10.7	–2.3
Capital services	1,038	850	861	968						
Total exports	**11,245**	**12,126**	**14,288**	**15,656**						
Import Surplus[b]										
Goods, excl. fuel and diamonds	232	1,173	1,913	1,554						
Current surplus of diamonds	95	67	158	118						
Total trade deficit	1,647	2,031	2,903	2,497						
Services, excl. capital services[b]	1,065	814	969	904						
Civilian, excl. capital services	331	974	1,759	1,551						
Net imports of capital services	1,664	1,651	1,576	1,669						
Total civilian import surplus	1,995	2,625	3,335	3,220						
Total import surplus	**3,847**	**3,827**	**5,807**	**5,326**						

[a] Imports c.i.f., exports f.o.b.
[b] Excluding trade with Judea-Samaria and Gaza.
SOURCE: Based on data of the Central Bureau of Statistics.

b) A rapidly rising trend in net investment from abroad continued in 1988, despite the expectations of devaluation (Table 7.A–8). That increase was an expression of confidence in continued stability and the prospect of sustained economic growth.

c) The risk premium on loans raised abroad—reflected by the gap between interest rates charged to Israeli borrowers and that for low-risk borrowers in the Western countries—declined after the stabilization program, and remained low also in 1988.[6]

d) The magnitude of capital movements and their patterns of behavior—especially the massive capital imports in the first quarter of 1989, after the last devaluation—indicate expectations that the stable exchange rate regime would be maintained. The correlation between expectations of devaluation and the scale of capital movements increased only towards the end of 1986, after the new policy gathered credence, and continued in early 1989, as mentioned before (see Fig. 7.6).

This evidence indicated the public accorded a low probability to a balance of payments crisis in the near future and a deviation from the stable exchange rate regime. However, continuation of the present exchange rate regime, with devaluations from time to time, is consistent with a persistence of inflation at a level higher than in the Western world. The evidence cited above, therefore, cannot be taken as a harbinger of expectations that the inflation rate will fall. On the contrary, it may signal that inflation is expected to remain on its present plateau.

Balance of payments stability is therefore the key to continued general stability. Last year's Annual Report presented a detailed evaluation of balance of payments developments since 1985. The conclusion of that analysis was that with the adoption of the 1985 stabilization program a turning point was reached as a substantial improvement in the balance of payments was achieved. This rested primarily on the elimination of the government deficit, achieved in part by additional foreign aid, and in part by slashing the domestic deficit. Another conclusion of that discussion referred to the economy's ability to attain steady balance of payments stability, which requires that structural problems inherited from the past be solved: the accumulation, over many years, of budget deficits which expressed itself in mounting domestic and foreign debt, to a size large in relation to GNP. The large proportion of public consumption in GNP must be added to these. The ratio of the public debt and

[6] Data on interest rates on credit from abroad are provided in 'Israel's Foreign Debt', Controller of Foreign Exchange, Bank of Israel.

public consumption to GNP is easier to reduce when economic growth is rapid. In order to attain steady growth, it seems to be necessary to increase the share of investment in GNP, at least for several years.

From the foregoing analysis is appears that not much progress was made in 1988 on the road to steady balance of payments stability. The current account remained favorable, but this occurred while the rate of growth dropped sharply, public expenditure rose, the budget deficit increased, and investment declined. The fall in investment is especially marked when seen against the rapid growth, in the last two years, of product and investment in most industrialized countries and in some of the more advanced among the developing countries. In 1987 the Israeli economy participated in these developments, but its growth receded in 1988. This leads to two guidelines for policy : one has to do with the importance of fiscal discipline in order to preserve balance of payments stability and the confidence that has been achieved with so much effort; the other underscores the importance of expanding investment in order to attain long-term balance of payments stability. The preferable way to achieve this is, of course, to decrease the ratio of consumption to GNP, thereby releasing domestic resources for investment. But there is also a case for a temporary increase in the debt/GNP ratio (taking account of its decline in recent years), in order to provide the economy with additional investment resources if and when they are not available from domestic saving. In line with this approach, a reform was initiated in 1987 intended to improve the domestic capital market. In 1988, this was complemented by a gradual liberalization of capital movements. Additional measures for relaxing the foreign exchange controls were introduced in early 1989. The liberalization is also important in that it compels producers and investors to adapt their economic decisions to the price of capital confronting the economy.

2. THE CURRENT ACCOUNT

The current account deficit decreased from $970 million in 1987 to about $680 million in 1988. The 'adjusted' current account, however (which excludes advances on defense imports), recorded a deficit of $200 million, compared to $240 million in the previous year, reflecting a decline in the import surplus and in net unilateral transfers. This relative stability in the 'adjusted' current account was comprised of a series of particular developments—principally the fall in the volume of exports, the unchanged import volume, and the

considerable improvement in the terms of trade. Also remarkable, in view of the scale of the year's capital exports, is the moderate decline in the private sector's net unilateral transfers.

The 1988 volume of exports declined by some 2.5 percent while the import volume remained unchanged (see Table 7.3). This contraction of foreign trade expressed itself in a slight increase in the real-term civilian import surplus. At the same time, the terms of trade improved by some 5 percent, reducing the civilian import surplus in terms of current values. The changes in the civilian import surplus and its components reflected difficulties that had been evident previously, and with which the economy had to cope in the year under review, in addition to the petering out of special factors which operated to expand economic activity in the two preceding years. Several of these difficulties had already shown up in the two previous years, to which special problems were added in 1988—principally the impact of the events in the territories, which reflected themselves particularly in the export and import data, because of their nature.

The fall in export volume is an exceptional development in Israel's balance of payments. An examination of exports by main components (see Table 7.2) shows that a substantial part of the decline is attributable to the contraction of exports to Judea-Samaria and Gaza, and the fall in income from tourism due to the unrest in the territories. Farm produce exports also recorded an exceptionally steep decline due to climatic and other natural factors (see Chapter 6). The diamond industry also experienced special difficulties, contributing only marginally to export growth (see Chapter 6). However, the specific difficulties of these sectors provide only a partial explanation for the decline of exports, since their bulk—nondiamond industrial exports—contributed only little to total export growth. Industrial exports rose this year by only about 4 percent, and contributed 1.5 percent to total export growth. This was some 2.5 percent less than its average annual contribution between 1976 and 1985 (see Table 7.2). The events in the territories, and damage due to natural factors, affected this constituent of exports as well. But these hold no full explanation for the slowdown of export growth. Such a small increase in industrial exports had not been recorded since the second half of the 1970s, except for 1982 and 1983, when there were also exceptional occurrences at home and abroad. Behind this year's slight export expansion there was actual contraction in some industries. Growth continued only in exports of the metal, electronics, and chemical industries and services (excluding tourism, capital services and exports to Judea-Samaria and Gaza).

Considering the accelerated growth of world trade and the slackening of domestic demand, the slow increase of industrial exports was apparently due to cumulative supply-side difficulties, especially the erosion of export profitability. One indicator of this erosion is the real appreciation of the currency which, for the third year running, took the form of an excessive rise of domestic prices relative to export and import prices (see Table 7.1).

Another indicator of export profitability, real wages per unit of industrial product, rose on average for the year by 9.5 percent despite a tapering off of wage rises during the year (see Table 7.4). Excessive real wage increases accompanied the stabilization program almost from its beginning. An attempt to correct their level at the beginning of 1987 by a devaluation and the neutralization of part of its impact on wage costs did not prevent wage increases later on. (see Chapter 4). After the erosion of wages in 1984–1985, their cumulative rise in the last three years came to some 40 percent.

Yet another indicator of export profitability is the price index of tradeables abroad as compared to the prices of tradeable goods in Israel (see Table 7.4) This index reflects the differences between inflation rates in various countries and the changes in the cross rates of foreign currencies. During 1988 this index was eroded steadily, both relative to the five-currency basket and the four-currency basket which excludes the U.S. dollar. The continued rise of domestic prices, at a rate more than four times that in Israel's trading partner countries—and this despite the stable exchange rate in 1988—shows up clearly in these indexes (see Chapter 3). They also show that the strengthening of the European currencies and the Japanese yen against the dollar slackened in the course of the year, mainly in the third quarter; against the U.S. dollar this index of profitability had already become eroded in the two preceding years, while an improvement was recorded relative to the 4-currency basket. In contrast, profitability in 1988 fell considerably by this measure, both relative to the dollar and the other currencies.

Nonetheless, in the two previous years the erosion of profitability did not prevent exports from growing by a cumulative 16 percent (of which 10.5 percent occurred in 1987; see Fig. 7.3). In order to trace its full impact and the other causes of the slowdown, it is necessary to examine the course of events in the two preceding years.

Domestic demand rose steeply in 1986, accompanied by sharp changes in its composition. Demand for private consumer goods boomed, while the government's procurement from the defense industries contracted. These changes were only partly matched by changes in supply, principally because business

TABLE 7.4

Relative Wholesale Prices, Israel and Trading Partners, 1985–1989 I

(Index, 1986=100; end of period)

		Official NIS exchange rate against		Relative prices[a] at: Official exchange rate		Effective export exchange rate	Real wage per:	
		Dollar	5-currency basket	U.S./ Israel	4-currency basket[b] countries/ Israel	5-currency basket[b] countries/ Israel	unit of output[c]	day[d]
1985		1.179	1.000	118.2	89.8	109.83	82.10	81.48
1986		1.488	1.446	100.0	100.0	100.0	100.0	100.0
1987		1.595	1.678	91.5	104.4	95.83	104.81	109.89
1988		1.599	1.719	81.3	96.2	85.32	114.88	122.28
1985	I	0.733	0.572	115.5	77.9	107.22	88.76	85.85
	II	1.015	0.827	119.5	86.5	111.99	83.90	84.51
	III	1.487	1.273	123.5	97.1	112.06	75.72	73.73
	IV	1.481	1.329	114.1	97.5	108.04	80.00	81.84
1986	I	1.486	1.387	108.3	100.8	106.94	96.56	93.75
	II	1.485	1.420	100.9	99.8	100.75	101.16	101.41
	III	1.491	1.481	97.2	101.6	98.02	97.37	98.97
	IV	1.489	1.495	93.7	97.9	94.28	104.92	105.87
1987	I	1.601	1.660	96.6	107.7	101.06	100.07	103.21
	II	1.597	1.679	93.0	106.3	97.98	102.61	108.21
	III	1.608	1.678	90.9	101.2	93.87	103.14	109.06
	IV	1.573	1.697	85.4	102.5	90.41	113.42	119.08
1988	I	1.575	1.717	82.4	101.1	87.91	116.93	120.70
	II	1.578	1.718	81.0	98.4	86.46	114.65	121.34
	III	1.638	1.717	82.6	92.2	84.66	111.78	119.33
	IV	1.605	1.722	79.2	93.1	82.24	116.15	127.78
1989	I	1.809	1.912	84.2	94.5			

[a] The NIS exchange rate multiplied by the index of wholesale prices abroad, divided by the Israeli index of wholesale prices of industrial output for the domestic market (excluding food, and mining and quarrying).

[b] Average of the representative rates, weighted by the composition of Israel's foreign trade; the 5-currency basket includes the U.S.$, DM, £, Ffr. and Yen. The 4-currency basket excludes the dollar.

[c] W/(PX*E*Y) where W—nominal daily wage in industry (excl. diamonds); PX—dollar price of industrial exports (excl. diamonds); Y—output per day in industry (excl. diamonds); E—effective exchange rate for exports.

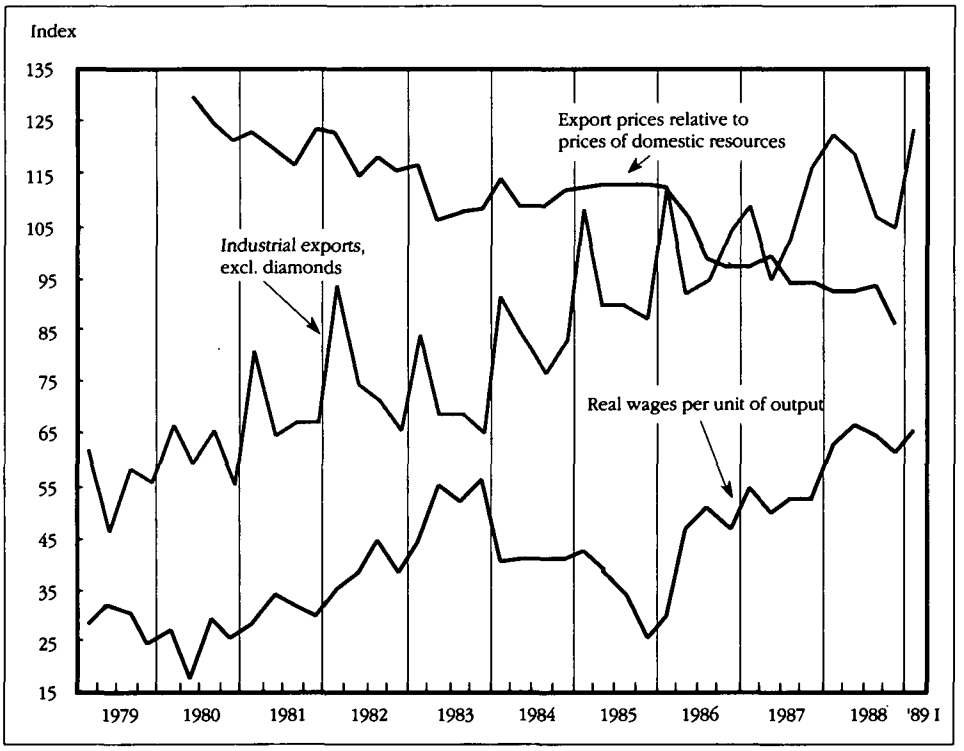
[d] W/(PX*E).

SOURCE: Exchange rates and effective exchange rates—Bank of Israel; wholesale price index, export prices, wages and output—Central Bureau of Statistics; prices in the U.S. and currency-basket countries—*International Financial Statistics.*

firms found it difficult to adapt quickly to the new economic environment created by the stabilization program. These adjustment difficulties expressed themselves, among other things, in a rise of real wages in excess of productivity growth , and an increase in the effective rate of taxation of the business sector. In view of these impediments, the high claims of domestic demand on domestic product caused the growth rate of industrial exports in 1986 to decline below their multi-annual average (see Table 7.2), and led to a substantial expansion of imports and the civilian import surplus.

The year 1987 was marked by continued expansion of output and employment, with a somewhat more moderate increase of domestic demand. The accelerated GNP growth of 1987—which occurred despite the substantial rise of real wages and other difficulties that weighed on the economy—primarily came from a strengthened sense of certainty, as inflation was throttled back and resources allocated to hedge against inflation were shifted to productive channels. The strong short-term effect of this factor tends to

Figure 7.3
Industrial Exports and Indicators of Profitability, 1978–88



SOURCE: Based on data of the Central Bureau of Statistics and Table 7.4.

peter out gradually. Continued rapid GNP growth therefore requires additional forces to be brought into play. In 1987 GNP growth was accompanied by an expansion of exports, but an examination of the multi-annual export trends (see Table 7.2) discloses that in most components (except diamonds) the apparent expansion of 1987 was merely a return to the multi-annual growth rate after the 1986 slowdown.

The 1988 expansion of exports was uneven among the sub-branches, and was especially marked in the textiles, clothing and food industries, where most exports are destined to Europe. Following a steady decline in their weight in exports and industrial output in previous years, these industries enjoyed a temporary boom in 1986 and especially in 1987, due to the strengthening of the European currencies. Exports of these industries have a history of remarkable response to changes in the cross rates of foreign currencies. In contrast, the primarily U.S.-oriented exports of the electronics and machinery industries exhibited less sensitivity to the dollar's weakening. Thus, despite some tapering in their growth rate, total industrial exports recorded a substantial expansion of volume in 1987. The 1988 exchange rate freeze against the dollar did not prevent significant expansion in industrial exports to the U.S. and an increase in their share in total exports.

Substantial tariff reductions, in the framework of the trade agreement with the U.S., led to an increase in exports to this destination—despite the continued weakening of the dollar in 1987. That expansion may have reflected a temporary readiness of Israeli exporters to accept lower profits in an effort to use the weakening of the dollar to capture a sizeable share of the U.S. market from the European countries. The stability of the exchange rate against the dollar later reduced this willingness to accept lower profitability.

The development of exports in 1988 therefore reflects a weakening of most of the special factors which caused their expansion in the previous year and, as can be seen from the above-mentioned indicators of profitability, a mounting of the supply-side difficulties in 1988.

The recessionary trend in the economy also reflected itself in the unchanged level of imports (excluding capital services). This stability is the result of sharp fluctuations in the various import components: a steep fall in imports of capital goods and production inputs (except for fuel and diamonds), and a substantial increase in imports of consumer goods—caused mainly by the decline in the relative price and higher expectations of devaluation in the second half of the year. Imports of fuel also rose, in response to the steep drop in their international prices.

A. Prices in Israel's Foreign Trade in Recent Years

The contraction of the volume of foreign trade in 1988 was accompanied, for the third year running, by a considerable rise in the dollar prices of most of its components. Export prices rose in the year under review by about 12 percent, while import prices went up by some 7 percent. We have no full explanation for the price rises of recent years, but several occurrences may shed some light on the reasons.

One central phenomenon is related to the changes in foreign cross rates. In the course of 1985, and in the years 1986 and 1987, the European currencies and the Japanese yen strengthened considerably against the U.S. dollar (see Table 7.A–7). Moderate rises were recorded in the prices of U.S. foreign trade, in dollars; at the same time there was a fall in the foreign trade prices of Europe and Japan, in their respective currencies. These price falls were much smaller than the rate of appreciation of the European currencies. Goods whose prices are set mainly in Europe and Japan thus became more expensive in dollar terms than goods priced in the U.S. market. These developments substantially affected the movement of Israel's foreign trade prices, due to the large share of trade with Europe in Israel's total foreign trade. Europe's share in total merchandise exports is estimated at 45 percent, while its share in total merchandise imports amounts to some 60 percent (see Table 7.A–6).

Figures 7.4 and 7.5 illustrate the development of the country's export and import prices relative to the changes in the five-currency basket, which is stated in dollars.[7] These graphs reveal the parallels between the changes in the exchange rate of the European currencies against the dollar, and those of Israel's foreign trade prices. The importance of geographical concentration shows up even more clearly when the foreign trade prices of the OECD countries, which are also denominated in dollars, are included. The trade of these countries is composed even more heavily of European goods, accounting for some 70 percent of their exports and imports.[8] It turns out that the movement of these prices is even more in line with the changes in cross rates.

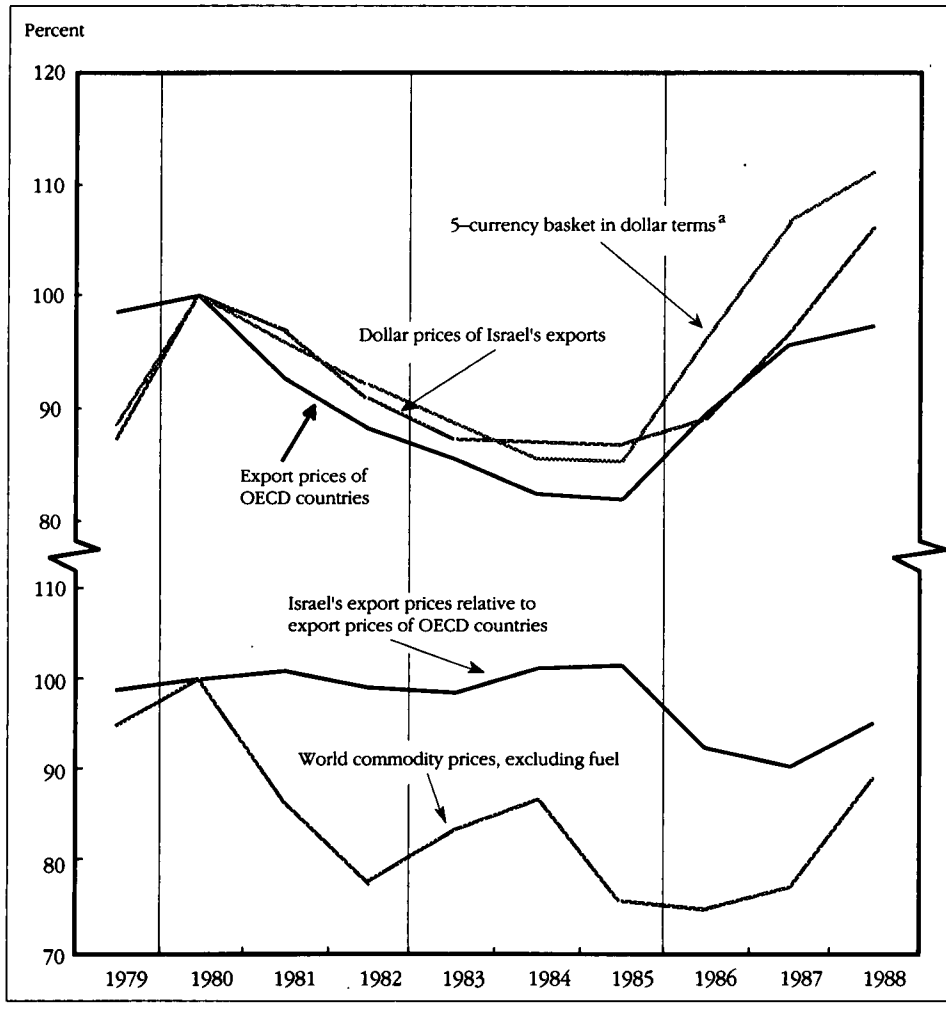
[7] The average of the representative exchange rates of the five currencies against the dollar, weighted in accordance with the composition of Israel's foreign trade.

[8] In order to adjust for part of the effect of the differences in the goods composition, Israel's import prices were compared to the prices of Europe's imports, and the prices of Israel's exports—to the prices of Europe's exports.

Figure 7.4

Export Prices, Israel and OECD Countries, 1979–88

(Annual rate of change, percent)



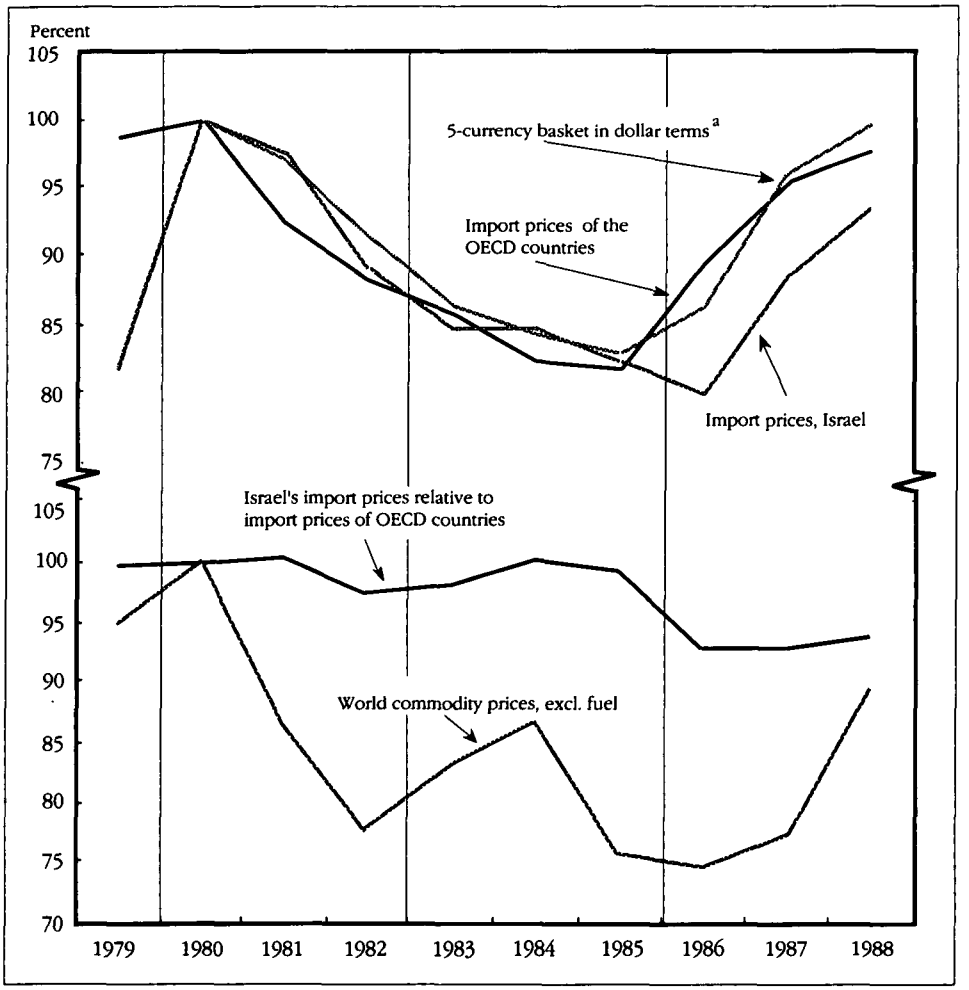
[a] Average of representative exchange rates of the five currencies, weighted in accordance with their proportion in Israel's foreign trade.

SOURCE: 5-currency basket and dollar prices of Israel's exports—Central Bureau of Statistics and Bank of Israel calculations; exports prices of OECD countries—OECD, *Economic Outlook*; IMF, *World Economic Outlook;* world commodity prices—OECD, *Economic Outlook*.

Figure 7.5

Import Prices, Israel and OECD Countries, 1979–88

(Annual rate of change, percent)



[a] Average of representative exchange rates of the five currencies, weighted in accordance with their proportion in Israel's foreign trade.

SOURCE: 5-currency basket and dollar prices of Israel's imports—Central Bureau of Statistics and Bank of Israel calculations; import prices of OECD countries—OECD, *Economic Outlook*; IMF, *World Economic Outlook*; world commodity prices—OECD, *Economic Outlook*.

In spite of the uniform trend of prices over time there were some years (1980, 1986 and 1988) in which price movements diverged from those of exchange rates, primarily in Israel's foreign trade prices. These deviations reflect other factors which operate in a direction opposite to that of the cross rates, and with varying intensity. Their influence is especially marked when the changes in cross rates are more moderate, as they were in 1988. Among the principal factors apparently also operating in the year under review was the steep rise in world prices of commodities and primary goods, following their decline in the two preceding years (Table 7.A–9).

This may also explain another facet of the changes in Israel's exports prices relative to those of the OECD countries. An attempt to isolate these prices from most of the influence of the currencies is presented in the lower part of Figure 7.4, which describes the movements in the price of Israel's exports relative to that of the OECD countries, by an index of commodity prices excluding fuel (based on Table 7.A–9). Both indexes show a similar trend, which may reflect a relatively large share of commodity-intensive goods in Israel's exports, as compared to the exports of the OECD countries. A similar picture, supporting the hypothesis about the composition of exports, emerges from the data for imports (Figure 7.5). This is because of the large share of the mutual trade of the OECD countries, which are generally more highly industrialized than Israel. To verify this hypothesis, the composition of Israel's exports was compared to that of several OECD countries, and the same comparison was made for imports. The component of imported inputs was examined with the use of Israel's input-output tables, on the assumption that its coefficients may provide a rough indicator also for the input import components of the other countries. The examination showed that Israel's foreign trade indeed contains a relatively high proportion of commodity-intensive goods (food products, chemicals, nonmetallic minerals, metals, textile fibers, etc.—codes 1–6 of the Standard International Trade Classifi-cation). As against this, Europe's trade contains a larger proportion of industrial goods with a high local value-added content (machinery, electrical and electronic equipment, transportation equipment, apparel, photographic equipment, etc.—codes 7–8 of the SITC).

An analysis of the contribution of different industries to the overall rise in export prices in 1988 is consistent with these findings: the major portion of the prices increases came from industries that export mainly commodity-intensive goods. In imports, too, the price rise is principally in the production inputs component (excluding fuel), which is also affected by the rise in international commodity prices. The rise in the prices of diamonds also affected export and

import prices, while the rise in import prices was in some degree a result of the sharp drop in fuel prices.

Another explanation for the considerable increase of export prices has to do primarily with the supply side of firms. It is generally assumed that Israel's share in world trade is too small to affect world prices. But this assumption may not be valid for some of Israel's export goods. It is possible that, in view of the stability of the sheqel exchange rate and supply-side difficulties, some Israeli exporters were induced to raise their prices. This came after several years of considerable export expansion, accompanied by relatively moderate increases in its dollar prices relative to the 'international price level', as reflected in the export prices of the OECD countries. Such exceptional price rises may also explain why export volume shrank despite the expansion of world trade.

Furthermore, the rise in export prices may reflect a statistical bias which cannot be measured directly. It is possible that in the conditions of stagnation that prevailed in the economy in the year under review, the slackening of domestic demand made itself felt mainly in expensive higher-quality goods characterized by a high income elasticity.[9] A shift of production surpluses of such goods to exports expresses itself in a rise of prices, even though it reflects qualitative changes. Changes in the quality levels of exports may also reflect the push given in recent years by the expansion of imports to the development of higher-quality products.[10]

B. Trade with Judea-Samaria and Gaza

The export surplus to Judea-Samaria and Gaza contracted in 1988 from an annual average of $220 million in the preceding three years to about $40 million (see Table 7.8). This decline is the sum of a substantial decrease in the volume of both exports and imports. As a result of the unrest, income from exports to the territories declined by about $280 million—equivalent to about 3 percent of Israel's total exports. Imports from Judea-Samaria and Gaza were down $150 million, leading to a 2 percent decline in Israel's total imports.

The major component of imports from Judea-Samaria and Gaza is labor services, which recorded a sharp quantitative contraction as workers from the

[9] Table 2.5 provides an indication for this.

[10] A partial indication of this may be found in the comparison of the CPI "basket" in 1985 to that of 1987.

territories absented themselves from work in Israel. This absenteeism was the major cause for the considerable rise in their wages (see Chapter 4). The composition of exports to Judea-Samaria and Gaza which took shape after the removal of trade barriers between the economies of Israel and the territories remained virtually unchanged over the years. Exports were mainly manufactured goods, among which the leading sub-sectors were non-metallic minerals (cement), food, textiles, chemical, plastics and basic metals. Exports

TABLE 7.5

The Balance of Payments with Judea-Samaria and Gaza, 1985–88

					Change over previous year, percent					
					Price			Quantity		
	1985	1986	1987	1988	1986	1987	1988	1986	1987	1988
	$ million				*Percent*					
1. Imports from Judea-Samaria and Gaza										
Merchandise imports	181	275	304	170	20.1	4.7	8.5	26.2	5.7	–48.4
Services imports'	301	453	669	657	51.3	29.3	28.6	–0.7	14.4	–23.6
of which: Wages	285	432	643	645						
Total imports from JSG	**482**	**727**	**973**	**827**	37.8	20.5	23.9	9.4	11.1	–31.4
2. Exports to Judea-Samaria and Gaza										
Merchandise exports	600	798	928	650	15.1	10.7	17.1	15.6	5.0	–40.2
Services exports	133	172	220	219	18.8	11.9	15.9	8.5	14.7	–14.2
Total exports	**733**	**970**	**1,148**	**869**	15.7	10.9	16.8	14.3	6.7	–35.2
3. Export Surplus to Judea-Samaria and Gaza										
Merchandise	419	524	624	480						
Services	168	281	449	438						
Total export surplus	**251**	**243**	**175**	**42**						

SOURCE: Bank of Israel calculations from Central Bureau of Statistics data.

to the territories contain a high proportion of imported goods which undergo no further processing in Israel. Their proportion in Israel's total exports is therefore greater than their contribution to GDP. The average contribution of exports to Judea-Samaria and Gaza to business sector GDP in 1985–87 has been estimated at about 1.7 percent.

The substantial contraction of sales to the territories represents a loss of only half a percent of business sector product. However, it should be pointed out that the decline in exports was uneven among industries. It was especially pronounced in textiles and cement, in which the areas account for a significant slice of total trade (see Chapter 6). In the textiles and apparel industries, the

effect of the disruptions of trade is more complex, since these goods are in part also sent to the territories for subcontracted processing at relatively low cost, after which they are returned to Israel. Disruptions in this activity have no major impact on the export surplus to the areas, but they can impair Israel's competitiveness in the domestic market and abroad, at least in the short run, if Israeli producers must recruit alternative labor at a higher cost to satisfy demand. The slack in domestic demand in Israel in 1988 indeed counteracted wage cost rises due to this factor. But it cannot be ruled out that the contraction of exports, together with the substantial rise in their prices, in part reflects a decline in the economy's competitiveness caused by the uprising. Other exports to Judea-Samaria and Gaza, such as fresh farm produce and cement, are particular to these areas, since they are by nature nontradable and have no alternative outlet in exports. Israel's trade figures therefore reflect the contraction of sales to the areas in full, at least in the short run.

C. Unilateral Transfers

A decrease of about $200 million in unilateral transfers was recorded in the year under review—$140 million in transfers to the private sector and $60 million to the public sector (Table 7.6).

The chief source of unilateral transfers to the public sector is U.S. aid (see Table 7.7). In recent years this aid has consisted of $1.8 billion of military aid and another $1.2 billion of a civilian grant-in-aid. The amount to which the military aid grant is drawn upon varies slightly from year to year, and declined this year by about $75 million. The civilian grant was approximately equal in size to this year's debt service on account of principal and interest to the U.S. government, amounting to $1,240 million. This grant was in previous years increased to correspond to the amount of debt service to the U.S., and the size of the debt burden presumably served as a justification for this grant in the U.S. administration and Congress.

In view of the capital exports this year, there was only a slight decline in unilateral transfers. These are affected by the relative profitability of holding financial assets in Israel instead of abroad and by the risks involved in doing so. Between 1983 and mid-1985 unilateral transfer declined for such reasons, as the public feared a balance of payments crisis and was afraid that financial assets would be taxed. After the implementation of the stabilization program, between 1985 and 1987, unilateral transfers doubled, and in 1988 they declined by only 8.5 percent. Considering the strong expectations of devaluation in the

TABLE 7.6

Unilateral Transfers, 1978–88[a]

($ million)

	1978–83	1984	1985	1986	1987	1988
1. Private sector						
Personal restitutions from Germany	426	323	328	424	531	558
Personal remittances	568	367	316	630	826	670
of which: Immigrants	240	98	82	354	500	348
Others	328	267	234	277	328	322
Personal transfers in kind	25	20	16	21	24	25
Transfers of private nonprofit institutions	199	190	170	186	290	290
Private transfers to abroad	–105	–136	–73	–65	–86	–90
Total, private sector, net	1,112	764	757	1,198	1,587	1,452
2. Public sector						
Transfers of national institutions	319	327	397	411	314	337
Intergovernmental transfers[b]	1,317	2,191	3,843	3,772	2,940	2,861
Total public sector, net	1,636	2,518	4,240	4,183	3,254	3,198
3. Total unilateral transfers, net	**2,748**	**3,282**	**4,997**	**5,382**	**4,839**	**4,650**

[a] Differences in totals are due to rounding.
[b] Includes military and economic grants.

SOURCE: Based on data of the Central Bureau of Statistics.

TABLE 7.7

U.S. Government Aid, 1984–1988

($ million[a])

	1984	1985	1986	1987	1988
1. Grants	2,271	3,885	3,817	2,981	2,907
of which: Military	1,071	1,935	1,867	1,781	1,707
Civilian[b]	1,200	1,950	1,950	1,200	1,200
2. Medium and long term loans	950	0	405	270	156
3. Repayment of medium and long term loans[c]	1,047	1,055	1,081	1,129	5,943
of which: Principal[c]	174	109	135	165	4,867
Interest	873	946	946	964	1,076
4. Total gross aid (1+2)	**3,221**	**3,885**	**4,222**	**3,251**	**3,063**
5. Total net aid (4–3)	**2,174**	**2,830**	**3,141**	**2,122**	**–2,880**
of which: Net receipts from loans	776	–109	270	105	–4,711
Grants less interest payments	1,398	2,939	2,871	2,017	1,831

[a] Differences in totals are due to rounding.
[b] Includes the emergency grant of $750 million a year in 1985 and 1986.
[c] Includes the redemption of $4,704 million in 1988, through the substitution of part of the U.S. government loans by issues of negotiable bonds carrying a nearly full U.S. government guarantee.

SOURCE: Based on data of the Central Bureau of Statistics.

year under review, there appears to be a steady and lasting decline in the risk which individuals attribute to holding financial assets at home.

The deduction, in the 1988 foreign debt statistics, of nonresident foreign currency deposits held by Israelis from the foreign debt (see below) also led to a change in the definition of private sector unilateral transfers. These now include the deposits in nonresident foreign currency accounts held by Israelis. Under the former definitions, unilateral transfers included the amounts converted into sheqels out of these accounts. Under both definitions, these deposits exhibit similar developments over time.

3. THE CAPITAL ACCOUNT AND THE FOREIGN DEBT

A. Capital movements

Given the low current account deficit in 1987 and 1988 (after deduction of past advance payments for direct defense imports), the capital account in these two years is marked mainly by the speculative cycle related to the two devaluations, and by two non-recurring events: the conversion of part of the debt to the U.S. government ($4.8 billion) into bonds floated on the U.S. capital market, and the redemption of $800 million worth of bank shares held by foreign residents under the 'arrangement'. A discussion of the speculative cycle requires distinction between the activities of the private sector on current and capital account and the operations of the public sector. These are both conceptually and statistically difficult to disaggregate, and the distinction may be regarded as no more than an approximation to actual developments (Table 7.A–4).

The private sector's derived capital imports—defined as the difference between its foreign currency purchases from the Bank of Israel and the private sector's current account—are the sum total of the transactions of individuals on capital account in all its components. Developments in the course of 1987 and 1988 were characterized by a clear speculative cycle.

The course of the speculative cycle has its explanation in the rise of the public's expectations of devaluation. The black market premium on the dollar expresses, among other things,[11] such expectations in the short run. There is a

[11] The black market dollar premium is also influenced by other factors, but it seems that expectations of devaluation are the dominant factor.

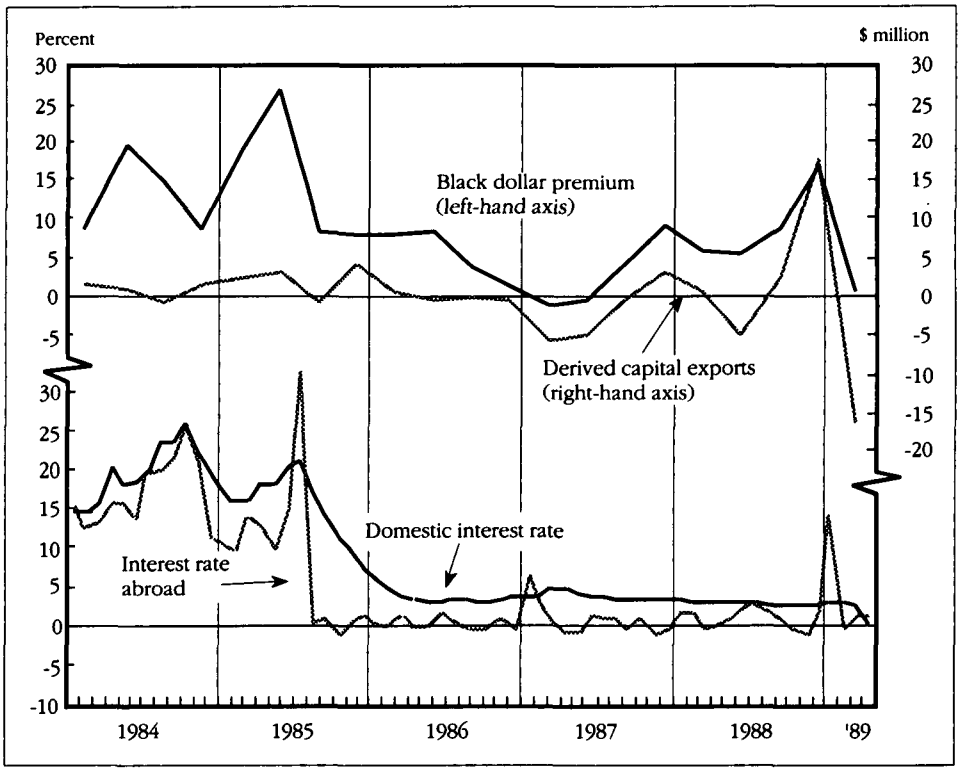
clear correlation between this premium and the size of capital movements (see Figure 7.7). After the nominal devaluations in January 1987, the black market dollar premium reflected the public's expectation that the exchange rate would remain stable in the short term. This expectation induced large-scale capital imports in early 1987. Towards the end of 1987 there arose moderate expectations of devaluation, accompanied by capital exports on a modest scale. When no devaluation was carried out in early 1988, the expectations of an imminent devaluation weakened, the black dollar premium declined slightly, and there were small-scale capital imports. Towards the end of 1988, expectations of devaluation became gradually stronger and expressed themselves, in the last quarter, in a surge of the black-market dollar premium (to about 17 percent) and in capital exports of $1.8 billion. The ensuing fall in the foreign currency reserves towards the end of the year led to a first round of devaluation of 5 percent in the last week of 1988 and an additional round of 8 percent at the beginning of January 1989, accompanied by a series of other economic policy measures. Expectations of devaluation then abated, and in the first few months of 1989 the black dollar premium fell to around zero—evidence that the public accorded a low probability to a further devaluation in the short term. At the same time the public returned to large-scale sales of foreign currency to the Bank of Israel. The derived capital imports are estimated at $1.7 billion in the first quarter of 1989.

One consequence of a stable exchange rate regime—as long as domestic inflation is higher than in the Western countries—is cyclical capital movements of a certain size. This is perhaps a price that has to be paid in the present economic circumstances for the advantages of such a regime.

TABLE 7.8
The Speculative Cycle, 1987–88

	1987		1988			1989
	1st half	2nd half	1st half	Quarters III	Quarters IV	I
Derived capital imports of the private sector, $ billion	1.1	–0.3	0.4	–0.2	–1.8	1.7
Black dollar premium, percent	–0.7	6.5	5.8	8.6	16.7	0.3
Effective monthly interest rate on overdraft facilities, percent	4.3	3.7	3.4	3.1	3.0	3.0
Monthly interest on Treasury bills, percent	1.9	1.1	1.0	1.0	1.5	1.4

Figure 7.6
Factors in Capital Movements, 1984–89



The deleterious effect of speculative capital movements is expressed in instability in the money markets. When capital is imported, liquidity in the economy rises and depresses the domestic short-term interest rate; when capital is exported, liquidity contracts, foreign currency reserves fall, and pressures are generated for a nominal devaluation. In early 1987, as capital imports increased, monetary policy was to raise interest rates in order to mitigate the effects of these imports—an expansion of domestic demand and a real appreciation of the currency. Subsequently, the main effort was to bring interest rates down from their high level; these efforts were intensified in 1988 when the slack in economic activity became apparent. Interest rates declined until October 1988, and rose only moderately towards the end of the year, the time of the devaluation. However, the size of capital movements is influenced not only by expectations of devaluation, but by the overall gap between interest rates abroad and those of the domestic market, the movements of which were described above (Fig. 7.6). Monetary policy did not therefore reduce the swings

in the capital movements cycle. As said before, guarding the foreign reserves is only one objective of monetary policy—and in 1987 and 1988 not the principal one. However, in the conditions of the Israeli economy even a monetary policy oriented exclusively to regulating capital movements would not have been able to prevent the speculative cycle, and at most might have moderated it in some (unknown) measure. The price for that would have been fluctuations in the domestic interest rate and their effects on economic activity.

The foreign currency purchases shortly before the devaluation and the resales immediately afterwards carry a cost for the public purse. For the end of 1988 cycle this cost is estimated at over NIS 250 million (even after deducting the local-currency interest, which expresses the cost of financing the transaction).

After the devaluation at the beginning of 1989 there were two changes which will permit a more flexible response of monetary policy and its effectiveness in limiting future capital movements: the resumption of the decline in domestic interest rates early in the year, and the setting of a range of float, of 3 percent above and below the currency-basket exchange rate while maintaining the stable exchange regime. Interest rates must decline after a devaluation if they are to be used as an instrument of response to rising expectations of devaluation while still holding interest rates at a reasonable average level throughout the cycle of expectations. The setting of the range of float in the stable exchange rate was intended to gain some of the benefits of a floating exchange rate while retaining most advantages of a stable exchange rate regime. Changes in the exchange rate within this margin, in response to expectations of devaluation, limit the expected profits from devaluation and, therefore, capital movements. The exchange rate thus declined after the devaluation, in response to the capital imports and the rise in the foreign currency reserves.

The private sector's capital exports in the second half of 1988 were larger than the capital imports in early 1987. The sum total of capital movements from one devaluation to the other indicates that net capital exports in this period amounted to $800 million. This does not signify any trend in capital imports to Israel, because the size of capital imports after a devaluation is influenced by capital exports before it, reflecting the adjustment of the public's asset portfolio to an expected devaluation. The capital imports of early 1987 included a small component of repatriation of capital which had flowed out before the devaluation (taking into account the relatively weak devaluation expectations and the absence of capital exports at the time). The capital imports at that time were induced mainly by the rise in domestic interest rates and the expectations that there would be no devaluation in the near term.

TABLE 7.9

Private Sector Capital Imports by Components, 1987–88

($ million)

	1987		1988	
	1st half	2nd half	1st half	2nd half
Total derived capital imports[a]	1,082	–297	439	–2,024
Net investment from abroad[a]	33	114	68	149
Long-term credit	234	93	–16	–185
Short-term credit	–17	23	86	–106
Capital imports through the banking system	487	–364	221	–1,328
Errors and omissions	345	–162	79	–553

[a] Excludes the redemption of the bank shares under the 'arrangement.'

Before the end of 1988, capital was exported on a large scale because very strong expectations of devaluation had prevailed for a long time (which permits portfolio adjustments even when credit facilities are not very flexible). For this reason alone, it could have been expected that after the January 1989 devaluation, capital imports would be sizeable. This is true despite the fact that domestic interest rates did not rise after the devaluation to induce an expansion of capital imports, as had been the case after the devaluation of early 1987. Preliminary estimates indeed indicate that the size of capital imports in the first quarter of 1989 was similar to capital exports in the last quarter of 1988, on the eve of the devaluation.

The private sector's operations on capital account are subject to a broad range of controls which restrict foreign currency transactions in various degrees, depending on the nature of the transaction. The success of the foreign exchange controls in reducing capital movements is difficult to assess (since there is no way of estimating what these movements would be in the absence of controls). However, the experience of this and previous years indicates that controls cannot stem capital movements. These had already at times been at a level of about $500 per quarter, and rose to a peak of $1.8 billion in the last quarter of 1988. Israel's experience in this respect is no different from that of other countries. In economies with large foreign trade (and consequently great financing flows) the authorities find it difficult to prevent speculative capital movements with the instruments at their disposal. The difficulty arises from the necessity as well as desirability of permitting those capital movements required for reasonable international trade activity. The side effects of the controls are reflected in distortions stemming from prohibitions and regulations that discriminate between various credit sectors.

It has been argued that the ability to maintain a substantial gap between domestic interest rates and those abroad evidences the effectiveness of foreign exchange controls. It is, however, also possible that the high marginal rate of interest in Israel is due to great differences in the access of various sectors to international money markets. Partial evidence for this discrimination between different borrowers in Israel is found in the great disparities between the cost of the credit baskets of various sectors (see Chapter 8). Moreover, the under-utilization of the foreign currency credit funds for exporters in recent years also indicates that the flows of credit between different borrowers are limited. The continued relaxation of restrictions on capital movements must nevertheless be carried out gradually as long as domestic inflation exceeds that prevailing abroad while the exchange rate remains stable. Some of the foreign exchange controls were relaxed in 1988, and the impost on credits raised abroad was abolished. A further step in this direction was taken at the beginning of 1989, within the framework of the efforts to reduce interest rates and the financial margins of the banks, through greater competition in the financial markets. The ceiling on nondirected bank credit in foreign currency was raised, exporters were permitted to take up direct credits from abroad even for short terms,and the minimum term of direct credits from abroad, within the framework of the general permit, was shortened from 30 to 18 months.

The existence of a foreign exchange control system influences the behavior of individuals and shifts credit flows from restricted channels to those which are relatively free from controls. The distribution of total capital imports by its various components thus reflects, in addition to economic considerations, the response to the system of controls. The clear speculative cycle outlined in these two years thus makes it possible to discern the nature of each constituent part of capital imports.

Net investment from abroad: A negative investment from abroad of $580 million was recorded in 1988 (Table 7.A–8), but this reflects the redemption of nearly $800 million of the bank shares under the 'arrangement' held by foreign residents. The purchase of these shares in 1983 was also recorded as an investment from abroad in the foreign debt and balance of payments statistics. When this non-recurrent component is excluded, net investment from abroad rose in 1988 to approximately $220 million, continuing the upward trend evident since 1985. In the last two years developments in this component were not in accordance to the speculative cycle (Table 7.9); net investment was

more affected by individual transactions of sales of firms to foreign investors. Foreign investment by Israeli residents is subject to tight controls.

Long- and short-term credit: In the year under review, the private sector made direct net repayments—outside the banking system—of credit in an amount of some $200 million, after having taken up loans of about $320 million in the previous year (Table 7.A–4). The decrease in the balance of debt to the rest of the world was achieved by reducing the amount of new loans taken up by about $240 million, and by increasing the repayment of outstanding loans by about $290 million. The foreign exchange regulations permit taking up medium- and long-term credits from abroad (as distinct from short-term borrowings which are restricted to certain transactions only). This component of capital imports is therefore influenced by expectations of devaluation (Table 7.9), but it is less flexibly adjustable. As a result, already in the second quarter of 1988, a substantial anticipatory response was recorded in this item, because a devaluation was expected by the end of the year. Since the devaluation was not carried out at the beginning of the year, individuals expected it to be postponed to the end of the year, and shifted in the second quarter to more liquid credits—repaying long-term loans and taking up short-term credits. A substantial part of the adjustment of the debt over the entire speculative cycle was nonetheless carried out by adapting repayments and not only by taking up new loans—which suggests that the repayment conditions of part of these loans abroad were flexible, and similar in this respect to short-term credit. This is consistent with the greater freedom from controls of this channel as compared to short-term credit. The foreign exchange regulations permit the early repayment of suppliers' credit or that of the banking system, and in other loans a special permit for early repayment is also generally granted provided the major part of the term of the loans has already elapsed. These arrangements thus allow for a relatively high flexibility in this type of credit.

Short-term credit: Short-term credit may be taken up only for specific transactions, especially in the form of suppliers' credit to importers. As a result, the speculative cycle reflects itself in the data of this credit channel, but its proportion in total capital movements is small.

Capital movements of the commercial banks on behalf of customers: This segment is subject to relatively tight controls, since foreign currency-linked credit which the banking system is permitted to extend to businesses in Israel is subject to ceilings. Credit to exporters, and for fuel imports, shipping and air com-

panies is exempt from ceilings. Nevertheless, about half of the capital movements in the first half of 1987 and the second half of 1988 were carried out through this channel (Table 79). The capital exports of the banking system countered the transactions of the nonfinancial private sector in anticipation of the devaluation. The repayment of foreign currency credits to the banking system, and a substantial increase in foreign currency-linked deposits by the public, left the banking system with disposable resources, causing it to reduce its borrowing from abroad and increase its deposits there. For the second half of 1988 the repayment of foreign currency-linked credit to the banking system explains 44 percent of total capital exports through this channel. The increase in nonresidents' deposits of Israelis and deposits by exporters explains another 28 percent, the rise in residents' foreign currency deposits—17 percent, and about 11 percent was due to increases of residents' restitution deposits and the reduction of reserve requirements on them.

Errors and omissions: This item cumulates the differences between the trade flows and reported capital movements and the recorded change in the foreign currency reserves. It is therefore an indicator of unreported capital movements. As expected, its changes reflect the speculative cycle, and its size—in times of rising capital movements—amounts to 25–30 percent of the total capital movements of the private sector. The errors and omissions include capital movements created by changing the timing of transfers of export proceeds or payments for imports. In view of the magnitude of merchandise trade these may reach sizeable proportions. Leakages to the black market of demand and supply of foreign currency related to the movement of tourism are also included in this item.

In summary: The examination of the components of capital imports shows that despite the relatively tight controls, about half of them are carried out through the banking system, a third flows through unreported channels (assuming that the "errors and omissions" item mainly reflects these capital movements). The rest of the transactions go through direct short- and long-term borrowings abroad of the private sector. No evidence was found for the role of the speculative factor in net investment from abroad.

The redemption of the bank shares under the 'arrangement': From the beginning of 1983, the banks intervened indirectly in the stock market by creating demand for their shares via nonbanking subsidiaries abroad. Under the 'arrangement' for the redemption of the bank shares it was decided to include these shares in the arrangement, and to redeem them in October 1988.

In order to prevent a one-time large impact on the foreign reserves, the Ministry of Finance reached an accord with the banks that these redemption repayments would be spread over several years. This arrangement prevented a fall in the reserves. But since the redemption of these shares is recorded as a disinvestment, the net foreign debt balance for the year increased by the full amount of the redemption. Investment from abroad is not included in the foreign debt statistics, because it generally does not generate a liability of fixed amount and term to the rest of the world.

TABLE 7.10
Assets and Liabilities in Foreign Currency 1984–88
($ million[a])

	1984	1985	1986	1987	1988
1. Net liabilities (2–3–4)[b]	18,903	18,574	18,329	18,246	18,602
2. Liabilities[b]	22,893	23,289	24,178	25,440	24,356
Government	15,492	15,530	16,200	16,559	16,587
Nonbanking private sector	3,598	3,862	4,112	4,920	4,412
Banking system, net	3,803	3,897	3,866	3,961	3,357
3. Foreign reserves[c]	3,255	3,794	4,867	5,962	4,756
4. Exporters' credit to foreigners	735	921	982	1,232	998
5. Current liabilities	4,718	4,910	4,097	4,549	4,433
Banking system (short-term)	2,388	2,301	1,197	1,190	1,138
Nonbanking private sector (short-term)	941	1,116	1,249	1,558	1,345
Direct government debt (short-term)	158	2	25	0	100
Medium- and long-term debt repayable within a year	1,231	1,491	1,627	1,801	1,850
6. Net current liabilities (5–3–4)	728	195	–1,752	–2,645	–1,321
7. Current debt as percent of net debt	4	1	–10	–15	–7
8. Gross liabilities	29,522	29,545	30,753	31,887	31,108

[a] Differences in totals are due to rounding.

[b] The definition of the foreign debt was this year adapted to international conventions, and nonresidents' deposits of Israeli residents were deducted from it. The balance of these deposits stood at the end of 1988 at about $1 billion. The data on the debt in this table are in accordance with those published by the Controller of Foreign Exchange. The data of the Central Bureau of Statistics are slightly different, due to the different dates at which they were revised.

[c] Held by central monetary institutions.

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

Conversion of part of the debt to the U.S. government: This is reflected in the medium- and long-term loans item. The debt to the U.S. government included long-term loans (for 20–30 years) carrying a fixed interest rate which was set at the going rate of U.S. Treasury bills prevailing when the loans were granted—as much as 12–13 percent per annum. Under a special arrangement with the

U.S. government (which also applies to Egypt and Turkey, who received military aid in those years), most of the high-interest loans (in an amount of about $4.8 billion) were repaid in the second half of 1988 before their due date. Against this repayment the State of Israel floated bonds on the U.S. capital market carrying a 90 percent guarantee by the U.S. government. The State of Israel covered the remaining 10 percent of the guarantee by purchasing U.S. Treasury bills which were deposited in a special fund held by the U.S. issuing banks as collateral for the redemption of the bonds. This completed the collateral of these bonds and they were sold at yields to maturity of 9.5 percent, only half a percentage point higher than the interest on U.S. government bonds. This arrangement will, in the coming year, reduce the burden of interest payments on this debt by about $150 million, but the annual saving will decline over the years. The U.S. Treasury bonds are included in 'assets of the central monetary institutions,' but not in the foreign reserves of the Bank of Israel. It should be pointed out that this conversion makes no difference to the payments on account of principal, unlike arrangements made with some Latin American countries which in recent years were not able to service their debt.

B. The Foreign Debt and the Foreign Currency Reserves

The net foreign debt increased in the year under review by $350 million and rose to $18.6 billion—the result of a decrease of about $780 million in the gross debt and a sharp decline in assets, primarily a fall of $1,205 million in the foreign reserves (Table 7.10).

The definitions of the foreign debt were revised this year to conform with international conventions. Nonresidents' foreign currency deposits held by Israeli residents (mainly new immigrants) were deducted from the debt, since they do not represent a liability to the rest of the world. These deposits amount to about $1 billion.

In recent years there has been an improvement in the net foreign debt position. After a rapid increase of 16 percent between 1973 and 1984, the external debt declined in 1985 and has since remained stable at about $18.2 billion. As stated, it rose this year to $18.6 billion, but its ratio to GNP declined further as a result of the change in the dollar value of GNP.

The level of the external debt this year was affected, on the one hand, by the redemption of the bank shares, which represents a liability incurred in 1983 (see above) and, on the other, by adjustment of the private sector's portfolio which reached a peak by the end of 1988, prior to the devaluation. The debt

and the foreign reserves, as measured at this point of time, reflect a transitional level. The ratio of debt to GNP and foreign reserves to imports therefore has only limited significance this year (Figures 7.6 and 7.7).

The economy's burden of interest payments to abroad remained stable relative to income and exports (Table 7.11). The average interest rate on the net external debt rose by about one percentage point, reflecting the changes in international interest rates since mid-1987. The conversion of the debt to the U.S. government does not yet show up in this year's interest payments, but is included in its entirety in the debt service. Apart from this repayment, there has been no change in the ratio of debt service to the economy's foreign currency income.

TABLE 7.11
Indicators of the Foreign Debt Burden, 1984–88[a]

	1984	1985	1986	1987	1988	1988
$ million						
Interest on gross debt	2,730	2,578	2,370	2,286	2,503	
less Interest receipts	1,166	950	825	816	948	
Interest on net debt	1,565	1,628	1,544	1,469	1,556	
Other capital services						
Debit	143	123	131	151	133	
less Credit	25	89	25	45	21	
Repayment of principal[b]	1,083	1,227	1,488	1,627	6,578	(1,800)
Total net debt service[b]	2,765	2,889	3,138	3,203	8,247	(3,469)
Percent						
Interest/net debt[c]	9	8	8	8	9	
Real interest[d] /net debt	4	4	6	5	5	
Interest/net available resources[e]	6	6	5	4	4	
Net interest/exports[f]	17	16	14	11	11	
Net debt service/exports	30	29	29	25	58	(24)
Net debt service/exports + unilateral transfers	22	19	19	18	44	(18)
Net debt service/GNP	11	13	11	10	20	(9)

[a] Differences in totals are due to rounding.

[b] The figures in brackets exclude the conversion of the debt to the U.S. in 1988.

[c] Calculated with debt lagged six months.

[d] Deflated by five-year average of CPI for industrial countries, to express long-term expectations of inflation.

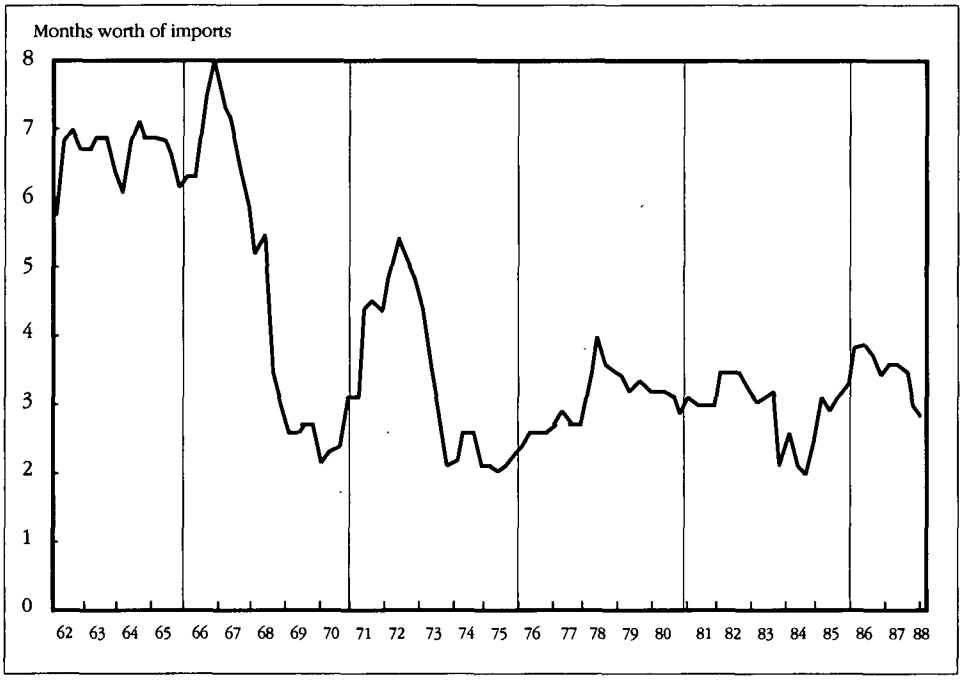
[e] Dollar value of GNP plus net unilateral transfers.

[f] Exports f.o.b., excluding capital services.

SOURCE: Based on data of the Central Bureau of Statistics.

Figure 7.7

Foreign Currency Reserves in Terms of Months of Imports, 1962–88

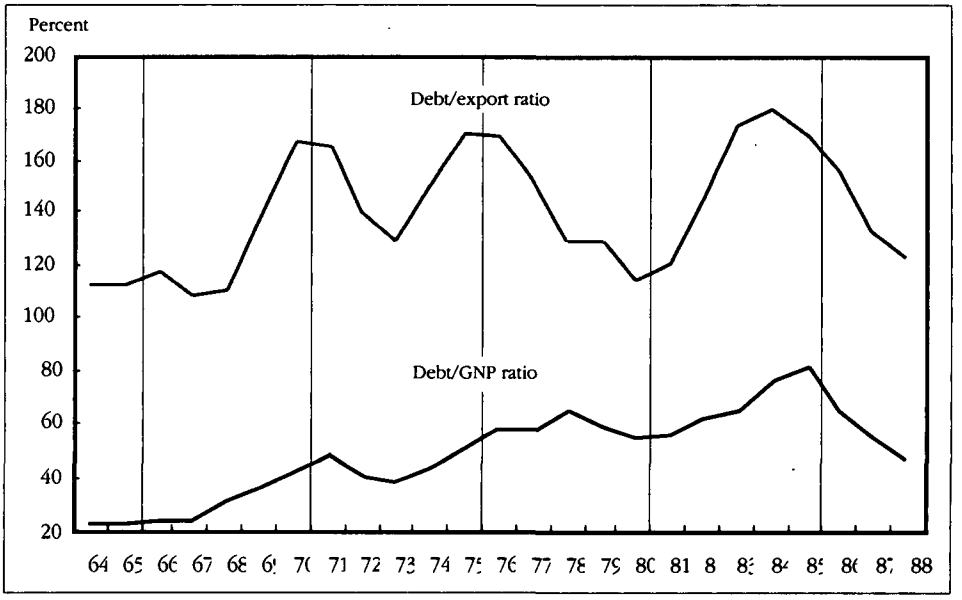


Definitions:

End of quarter balance of foreign currency reserves held by central monetary authorities divided by the average monthly imports in the previous 12 months at the end of the same quarter.

SOURCE: Based on data of the Central Bureau of Statistics.

Figure 7.8
Ratio of Foreign Debt to Exports and GNP, 1964–88



Definitions:

Foreign debt	Net foreign debt in current U.S. dollars, end-of-year.
Exports	Annual exports, f.o.b., in current U.S. dollars.
GNP	Gross national product according to the national accounts, converted into U.S. dollars at the official exchange rate.

SOURCE: Based on data of the Central Bureau of Statistics.

TABLE 7.A–1

Civilian Merchandise Imports by Economic Destination, 1985–88[a]

	$ million[c]				Percent annual change[b]					
					Price			Quantity		
	1985	1986	1987	1988	1986	1987	1988	1986	1987	1988
Consumer goods	621	1,029	1,337	1,549	18.8	14.4	2.6	39.5	13.5	12.9
of which: Durables	232	454	627	734	27.7	19.1	1.4	53.4	16.0	15.4
Capital goods	1,414	1,604	2,148	2,071	17.1	15.5	4.2	–3.1	15.9	–7.4
of which: Equipment and machinery	1,227	1,295	1,539	1,470	14.1	13.6	4.3	–7.5	4.6	–8.4
Vehicles	186	302	486	502	32.0	22.6	3.6	23.4	31.0	–0.2
Intermediates	6,162	6,846	8,216	8,936	–6.5	7.7	9.5	18.8	11.4	–0.7
of which: Fuel	1,510	924	1,148	1,062	–46.0	22.0	–20.4	13.3	1.8	16.2
Raw and polished diamonds, net	1,168	1,598	1,901	2,429	10.0	3.5	19.5	24.3	14.9	6.9
Other	3,483	4,324	5,168	5,445	4.4	6.5	13.8	18.9	12.2	–7.4
Gross n.e.s. less returned imports	–175	–195	–246	–259						
Total net, foreign trade statistics	**8,021**	**9,285**	**11,455**	**12,297**	–1.0	9.8	7.7	16.9	12.4	–0.3
Balance of payments adjustments	–372	–378	–415	–437						
Imports from Judea-Samaria and Gaza	181	275	304	170	20.1	4.7	8.5	26.2	5.7	–48.4
Total civilian goods imports, net, according to balance of payments definition (c.i.f.)	**7,831**	**9,181**	**11,344**	**12,030**	–0.5	9.7	7.7	17.8	12.7	–1.5
Total, net, excl. fuel, diamonds, and imports from Judea-Samaria and Gaza	**4,971**	**6,385**	**7,992**	**8,370**	9.0	9.8	9.5	17.9	14.0	–4.4

[a] Imports c.i.f., excluding direct defense imports.
[b] Rates of change were calculated prior to rounding.
[c] Differences in totals are due to rounding.

SOURCE: Central Bureau of Statistics.

TABLE 7.A–2

Merchandise Exports, by Sector of Origin, 1985–88[a]

	$ million[c]				Percent annual change[b]					
					Price			Quantity		
	1985	1986	1987	1988	1986	1987	1988	1986	1987	1988
Agricultural exports	468	560	609	573	5.8	17.1	14.7	13.0	–7.1	–18.0
Citrus	172	174	201	177	5.5	14.0	12.4	–4.0	1.1	–21.5
Other	296	386	409	396	5.8	18.1	16.4	23.1	–10.4	–16.7
Industrial exports[d]	4,349	4,709	5,534	6,317	2.5	7.5	9.9	5.7	9.3	3.9
Metals, machinery & electronic equipment	1,928	2,204	2,413	2,813	5.3	6.1	5.7	8.5	3.2	10.3
Other industrial exports	2,421	2,505	3,121	3,504	0.1	8.7	13.5	3.4	14.6	–1.0
Diamonds, net	1,263	1,664	2,059	2,547	3.9	1.4	20.9	26.8	22.0	2.3
Ships and aircraft	10	5	10	12						
less Returned exports	6	7	10	16						
Total net exports, foreign trade statistics	**6,084**	**6,933**	**8,201**	**9,433**	3.0	6.7	13.0	10.6	10.9	1.8
Balance of payment adjustments	–82	–57	–64	–70						
Exports to Judea-Samaria and Gaza	600	798	928	650	15.1	10.7	17.1	15.6	5.0	–40.2
Total, net, balance of payments definitions	**6,602**	**7,674**	**9,065**	**10,013**	4.2	7.1	13.2	11.6	10.3	–2.4
Total, net, excl. diamonds and exports to Judea-Samaria and Gaza	**4,739**	**5,211**	**6,078**	**6,816**	2.8	8.5	10.3	7.0	7.5	1.7

[a] Exports f.o.b.

[b] Rates of change were calculated prior to rounding.

[c] Differences in totals are due to rounding.

[d] Excluding diamonds, ships and aircraft.

SOURCE: Based on data of the Central Bureau of Statistics.

TABLE 7.A–3

Services Account, 1985–88[a]

	$ million[b]				Percent annual change[c]		
	1985	1986	1987	1988	1986	1987	1988
Imports							
Transport	947	909	1,078	1,245	–4.1	18.6	15.6
Tourism	549	799	1,041	1,130	45.5	30.2	8.5
Insurance	132	88	110	97			
Capital services	2,702	2,501	2,438	2,637	–7.4	–2.5	8.2
Other services	972	1,180	1,505	1,624	21.4	27.6	7.9
Government services n.e.s.	106	93	107	111			
Total	5,409	5,570	6,279	6,845	3.0	12.7	9.0
of which: From Judea-Samaria and Gaza	301	453	669	657	50.3	47.9	–1.8
Total, excl. Judea-Samaria & Gaza	**2,406**	**2,616**	**3,172**	**3,550**	8.7	21.2	11.9
Exports							
Transport	1,346	1,383	1,595	1,733	2.7	15.3	8.7
of which: Freight charges on imports, Israeli carriers	306	358	423	446	17.0	18.1	5.3
Tourism	1,101	972	1,347	1,343	–11.8	38.6	–0.3
Insurance	16	23	35	48			
Capital services	1,038	850	861	968	–18.1	1.3	12.4
Other services	1,124	1,203	1,355	1,516	7.0	12.7	11.8
Government services n.e.s.	16	21	28	35			
Total	**4,643**	**4,452**	**5,223**	**5,643**	–4.1	17.3	8.0
of which: To Judea-Samaria and Gaza	133	172	220	219	29.0	28.3	–0.5
Total, excl. Judea-Samaria & Gaza	**3,471**	**3,430**	**4,141**	**4,455**	–1.2	20.7	7.6
Deficit on services account	766	1,118	1,056	1,203	45.9	–5.5	13.9
Net imports of capital services	1,664	1,651	1,576	1,669	–0.8	–4.5	5.9
Surplus on services account excl. Judea-Samaria and Gaza	1,065	814	969	904	–23.6	19.1	–6.7

[a] *Imports c.i.f., exports f.o.b.*

[b] Differences in totals are due to rounding.

[c] Rates of change were calculated from less rounded figures.

SOURCE: Central Bureau of Statistics.

TABLE 7.A–4

Balance of Payments of the Private and Public Sector, 1986–88[a]

($ million, at current prices)

				1987		1988	
	1986	1987	1988	1st half	2nd half	1st half	2nd half
Public sector							
1. Goods and services account[b]	1,559	649	630	–188	837	–279	909
2. Medium- and long-term capital movements[c]	348	46	–668	–118	164	–44	–624
3. Basic account	1,907	695	–38	–306	1,001	–323	285
4. Short-term capital movements	7	0	108	–4	4	–7	116
5. Capital movements of the bank on behalf of the public sector	116	–123	591	–196	73	–262	853
6. Errors and omissions	–378	280	579	186	94	444	135
7. Effect of the public sector on the foreign reserves [increase (–)]	–1,651	–852	–1,240	320	–1,172	148	–1,387
Private sector							
1. Goods and services account[b]	–653	–885	–825	–244	–641	–239	–586
2. Medium and long-term capital movements[c]	173	474	16	267	207	52	–36
3. Basic account	–481	–411	–809	23	–434	–187	–622
4. Short-term capital movements	–63	5	–20	–17	23	86	–106
5. Capital movements of the banks on behalf of the private sector	–233	123	–1,108	487	–364	221	–1,328
6. Errors and omissions	119	183	–473	345	–162	79	–552
7. Effect of the private sector on the foreign reserves [increase (–)]	659	99	2,410	–838	938	–199	2,610
8. Derived capital imports of the private sector[d]	–6	785	–1,585	1,082	–297	439	–2,024

[a] Differences in totals are due to rounding.

[b] The current account is adjusted for identified transactions between the two sectors and therefore differs from the figures appearing in Table 7.A–1. Another difference is due to the adjustment for advances on defense imports.

[c] The redemption of the bank shares held by foreign residents was deducted from the private sector's capital movements, and is included in the capital movements of the public sector.

[d] Derived capital imports are defined as the difference between the private sector's purchases of foreign currency and its current account.

SOURCE: Central Bureau of Statistics.

TABLE 7.A–5

Industrial Exports by Main Branches,[a] 1985–88

	$ million				Percent annual change[b]					
					Price			Quantity		
	1985	1986	1987	1988	1986	1987	1988	1986	1987	1988
Mining and quarrying	241	233	235	244	–4.7	–3.6	16.6	1.2	4.5	–10.9
Food, beverages and tobacco	383	333	436	521	–12.2	13.0	30.6	–1.0	15.8	–8.4
Textiles	115	138	185	215	16.8	12.1	14.1	2.9	19.8	1.7
Clothing and made-up textiles	260	320	400	416	10.0	15.6	23.0	12.0	8.0	–15.4
Leather and its products	4	7	7	10						
Wood and its products	30	37	47	46	13.1	8.5	11.4	8.3	19.0	–12.2
Paper and its products	8	13	19	26	11.7	26.5	4.3	55.8	14.4	26.0
Printing and publishing	18	17	23	22	11.7	26.5	4.3	–15.6	7.8	–5.4
Rubber and plastic products	146	183	221	222	9.5	9.2	5.6	14.4	10.6	–5.0
Chemical and oil products	835	792	1,039	1,173	–6.6	6.1	8.9	1.5	23.6	3.6
Non-metallic mineral products	14	16	17	23	16.3	–0.1	13.2	–0.6	5.6	15.6
Basic metal	71	65	74	102	4.7	4.2	–6.8	–12.6	9.1	47.9
Metal products	508	531	555	668	3.1	4.7	7.7	1.5	–0.1	11.7
Machinery	138	163	212	195	9.9	6.2	8.1	7.3	22.6	–14.7
Electrical and electronic equipment	794	890	1.085	1.410	7.6	7.6	5.3	4.3	13.2	23.5
Transport equipment	415	556	535	438	1.8	4.1	3.5	31.7	–7.6	–20.9
Miscellaneous	334	378	446	538	10.5	10.2	7.4	2.6	7.1	12.3
Total, excl. diamonds and U.N.[c]	**4,349**	**4,709**	**5,534**	**6,317**	2.5	7.5	9.9	5.7	9.3	3.9
Diamonds, net	1,263	1,664	2,059	2,547	3.9	1.4	20.9	26.8	22.0	2.3
Total	**5,612**	**6,374**	**7,592**	**8,864**	2.9	5.7	13.3	10.4	12.7	3.1

[a] Exports f.o.b.

[b] Rates of change were calculated prior to rounding.

[c] Includes goods n.e.s. in a value of up to $50 million, in the years cited in the table.

SOURCE: Based on data of the Central Bureau of Statistics.

TABLE 7.A–6

Merchandise Trade by Area of Origin and Destination, 1983–88

(Percent of total, current U.S. dollars)

	1983	1984	1985	1986	1987	1988
Merchandise imports, by area of origin[a]						
Europe[b]	56	56	59	63	64	62
North America	29	31	30	25	22	23
Other	15	13	11	12	14	15
Total	**100**	**100**	**100**	**100**	**100**	**100**
Merchandise exports by area of destination[c]						
Europe[b]	45	42	40	40	43	44
North America	21	24	29	29	28	26
Other	34	34	31	31	29	30
Total	**100**	**100**	**100**	**100**	**100**	**100**

[a] Excludes direct defense imports.

[b] EEC and EFTA countries.

[c] Excludes diamond exports.

SOURCE: Central Bureau of Statistics.

TABLE 7.A–7

World Currency Cross Rates, 1986–88, *(Percent change)*

	1986	1987	1988	1987	1988
Against the US dollar, nominal				*End of year*	
Deutschmark	–26.2	–17.2	–2.3	–18.5	12.6
Sterling	–11.6	–10.5	–8.0	–21.2	3.4
Yen	–29.4	–14.2	–11.4	–22.4	1.9
French franc	–22.9	–13.2	–0.9	–17.3	13.5
Against the dollar, real exchange rate[a]					
Deutschmark	–27.1	–12.9	–0.1	–14.6	14.7
Sterling	–18.5	–11.5	–8.9	–20.5	2.2
Yen	–25.1	–8.5	–7.3	–17.6	7.0
French franc	–27.5	–13.8	–0.1	–15.8	14.2
Sheqel exchange rate against:					
US dollar	26.2	7.2	0.3	3.5	4.2
Deutschmark	66.7	29.1	2.7	27.2	–6.1
Sterling	39.1	19.8	9.0	31.1	1.8
Yen	75.1	24.5	13.0	36.3	2.4
French franc	59.1	23.4	1.3	24.2	–6.9
Currency basket[b]	37.2	14.3	2.4	13.9	0.7
Wholesale price index of industrial output[c]	45.0	18.9	17.4	20.5	14.1

[a] Exchange rate against the dollar, deflated by changes in wholesale prices in the respective countries.

[b] Average of representative exchange rates of the five currencies, weighted according to the composition of Israel's foreign trade.

[c] Excluding food, quarrying and mining.

SOURCE: Exchange rate and price indexes abroad—IFS; wholesale price index of industrial output in Israel—Central Bureau of Statistics.

TABLE 7.A–8

Foreign Investment in Israel and Israeli Investment Abroad, 1982–88

($ million[a])

	1982	1983	1984	1985	1986	1987	1988
1. Investment by foreign residents	832	1,363	183	218	294	399	398
of which: In securities traded on the stock exchange[b]	725	1,220	80	51	83	118	84
Direct investment	64	72	76	134	173	262	289
State of Israel bonds[c]	6	1	5	10	8	4	2
In goods	18	47	3	5	13	–4	0
Reinvestment of profits	18	22	20	17	17	19	22
2. Repatriation of investments by foreign residents	856	520	222	129	133	213	954
of which: Securities traded on the stock exchange[d]	800	465	171	61	66	163	855
3. Net investment of foreign residents	–24	842	–39	89	161	186	–556
4. Investments abroad by Israeli residents	210	382	55	81	121	115	63
of which: Securities	31	259	22	30	12	39	23
Direct investment	178	123	34	51	108	75	40
5. Repatriation of investments abroad by Israeli residents	32	3	78	91	83	75	35
6. Net investment abroad by Israeli residents	178	379	–23	–10	37	40	27
7. Net private nonbanking investment from abroad (3–6)	–202	463	–16	99	124	147	–583
8. Foreign securities held by the commercial banks[e]	29	1	–88	–38	–64	–37	44
9. Total net investment from abroad (7–8)	–231	462	72	137	188	184	–627

[a] Differences in totals are due to rounding.

[b] In 1983, includes investment in bank shares by corporations affiliated with the Israeli banking system.

[c] Bonds redeemed for reinvestment on the stock exchange.

[d] In 1988, includes $ 800 million of bank shares which were redeemed.

[e] Includes investment in foreign stocks by the banking system.

SOURCE: Based on data of the Banking Supervision Department, Bank of Israel, and the Central Bureau of Statistics.

TABLE 7.A–9

Fuel and Commodity Prices, 1984–88

(Percent change of dollar prices)

	1984	1985	1986	1987	1988
OPEC, average fuel price	–2.8	–4.9	–50.1	29.0	–20.4
Food	8.7	–15.3	2.0	–13.1	13.5
Agricultural raw materials	4.3	–14.8	–1.1	29.4	7.6
Metals and minerals	–6.5	–4.2	–9.0	17.2	40.3
All commodities, excl. fuel	4.2	–12.9	–1.2	3.4	18.2

SOURCE: OECD, *Economic Outlook;* IMF, *World Economic Outlook.*