

CHAPTER VII

ISRAEL AND THE WORLD ECONOMY – 1978

1. MAIN DEVELOPMENTS

A. THE WORLD ECONOMY – AN OVERVIEW

Output growth in the world economy during 1978 remained approximately at the level of the preceeding year. This stability however, reflected a moderate cyclical upswing in Europe, a gradual slowing of the US economy towards its full employment potential growth rate, and continued, fairly vigorous growth in most of the developing world. Specifically, the European growth average rose from a bit over 2 percent to about 3 percent, the US rate fell from 5 to about 4 percent, and the (non-oil) "LDCs" stayed in the area of 5.1 or 5.2 percent. In contrast to these groups, OPEC growth rates continued a steep slide from a peak in 1976 (6.2 percent and 2.5 percent in 1977 and 1978 respectively). This occurred despite the stability of world growth, primarily because of increased petroleum extraction (e.g. Alaska, North Sea, etc.) and more efficient use elsewhere. As a further consequence, the OECD countries replaced OPEC as the major trade surplus and capital exporting bloc. The LDCs collectively not only financed their large deficit, but achieved substantial reserve growth.

In line with stable, but below capacity GNP growth, world trade also remained stable at the low figure of about 5 percent. Inflation generally remained high by pre-1973 standards but tended to fall rather widely in Europe, Japan, and the developing countries (except the Middle East), while rising somewhat in the United States.

B. THE INDUSTRIALIZED COUNTRIES

Economic growth in the major industrial countries in 1978 progressed roughly in line with their leading monetary growth rates (fiscal policy generally following a more neutral trend) and somewhat in contradiction to major international forecasts.¹

¹ The IMF forecasts, for example, expected equal growth rates in Germany and France and slightly lower rates in the United Kingdom and Italy. Even the OECD "Outlook" of July 1978 forecasts a rise in French GNP of 3.25 percent vs one of only 2.75 percent for the United Kingdom and 2.5 percent for Germany. As Table VII-1 shows, the actual order is nearly the reverse. These errors, like earlier ones, appear to reflect mainly a tendency to underestimate the importance of the monetary factor (i.e. real money growth) for aggregate domestic demand growth.

TABLE VII-1

GROWTH OF REAL GNP IN OECD COUNTRIES, 1965-1978
(percentage, seasonally adjusted, annual rates)

	Average				1977			1978		
	1974/75		to		1977	1978	1978 ^a	2nd		1st
	1965/66	1977	1978	1978 ^a				half	half	half
1. Canada	4.7	2.7	4.5	3.5	2.5	4.1	3.8			
2. U.S.A.	2.7	4.9	3.8	3.9	5.1	2.8	4.5			
3. Japan	8.2	5.2	5.8	5.7	3.7	7.8	4.0			
4. France	4.7	3	3.0	2.9	2.7	3.4	2.8			
5. West Germany	3.3	2.6	3.0	3.4	2.1	2.8	4.0			
6. Italy	4.1	1.7	2.0	2.0	-3.6	4.2	3.3			
7. U. K.	2.1	1.6	3.0	3.2	3.0	3.1	2.5			
8. 4 major countries	3.6	2.4	2.8	4.1	1.6	3.2	3.3			
9. Total above countries weighted by OECD	4.0	4.0	3.8	3.4	3.6	3.9	4.0			
10. Other OECD countries	4.4	1.8	2.3		2.0	2.0	3.3			
11. Total OECD	4.1	3.7	3.5		3.4	3.6	3.8			

^a IMF data.

SOURCE: OECD, *Economic Outlook*, December 1978, Table 1.

Specifically, as Table VII-1² shows, the growth rate rose in Germany and the United Kingdom, while remaining at or near the low 1977 levels in France and Italy. In the United States and Japan growth continued at higher rates; in the former, in line with a more stable real monetary growth trend; in the latter, in response to more complex stimuli. Figure VII-2 shows that for the four largest European economies together the effect of higher nominal monetary growth in 1977 was to raise real M growth from about 2 to 6 percent (from 1976 to 1977). Real GNP growth subsequently rose from less than 2 percent during 1977 to about 4 percent during 1978.

² Nominal M₁ growth rates (December to December) rose from 1976 to 1977 by 10 percent and 5 percent in the United Kingdom and Germany, while they fell by 2.7 percent and 1.0 percent in France and Italy.

TABLE VII-2

UTILIZATION OF PRODUCTION CAPACITY AND UNEMPLOYMENT, 1964–1973, 1977 and 1978
(percents)

	Rate of utilization of industrial production capacity			Rate of unemployment ^b				IMF data ^d	
	Average 1964–1973	1977 IV	1978 III	1977 IV	1978			1977	1978
					I	II	III		
U.S.A.	85.4	82.9	84.9	6.9	6.1	5.8	5.9	7.0	6.0
Japan	92.6	83.3	8.0	(2.1)	(2.2)	(2.4)	(2.5)	2.0	2.3
Germany	8.3	80.8	80.2	(3.6)	(3.5)	(3.5)	(3.7)	4.3	4.5
France	84.8	83.1	83.8 ^a	(4.6)	(4.9)	(5.3)	(5.8)	5.0	5.4
Great Britain ^c	45.3	30.0	35.0	(6.3)	(7.0)	(6.8)	(6.8)	5.8	5.7
Italy	78.5	71.5	72.8	6.6	7.0	6.7	7.4	7.2	7.2
Average of 4 European countries	77.7	71.2	71.9	4.8	5.0	5.0	5.3		

^a Fourth quarter.

^b Figures in parentheses have been adjusted by OECD to common definition (identical to the American definition).

^c Percent of companies operating at full production capacity.

^d These data are based on different national definitions; they can therefore be used for temporal comparisons, but not for comparisons between countries.

Despite this rise, GNP growth outside the United States remained generally below potential rates. Unemployment and capacity utilization reflected the varying national trends. In the United States unemployment continued to fall, more slowly than in 1977 (from 6.6 percent in 1977 IV to 5.8 percent in 1978 IV), while it continued to rise elsewhere, with the largest increases in the slower growing European economies noted above (especially in France).

The long persistence (since 1974) of this slow rise in unemployment rates in response to below par growth has emerged as one of the most serious problems in Europe and Japan. However, the trend of growth appears to be positive and the corner may well be turned in this respect during 1979. The problem of relatively high rates of inflation on the other hand, exhibits more variability. It is true that the economy growing most strongly relative to potential, the United States, did experience an uptrend in inflation in 1978. Yet among other countries, similar policies of demand restriction and gradually growing slack achieved widely differing results in slowing inflation. There was a slight average downward trend in inflation outside the United States. But the United Kingdom, for example, with a relatively high 1978 growth rate, showed the sharpest reduction (from 16 to 8 percent). By contrast, France, with low growth and rising unemployment, barely reduced its rate of inflation of about 9.5 percent.

These varied results reflect the importance of factors other than demand restraint, particularly of "incomes policy" (or direct reduction of cost-push factors) and, on a more transitory basis, of shifts in exchange rates – which tend to be concentrated in short spasms. Such shifts particularly raised the United States and lowered the Japanese price index changes. The sources of the United States rise, however, went beyond this, to a faster rise in wages as well. Both developments – the fall in the US dollar and the rise of inflation – stimulated a decided swing in the United States towards policies of disinflation, including both monetary and fiscal restraint, and an innovative approach to price and wage restraint. The latter is to be exercised by withholding government contracts from firms which raise wages or prices beyond guideline figures and the (proposed,

FIGURE VII-1
REAL GNP GROWTH RATE
SEVEN MAJOR OECD COUNTRIES
1971–1978
 (Percent change, half years at annual rates)

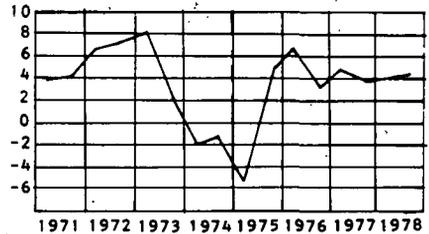
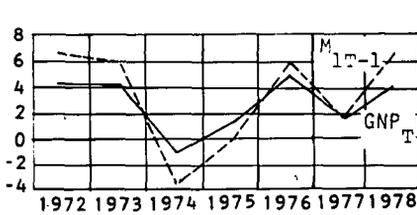
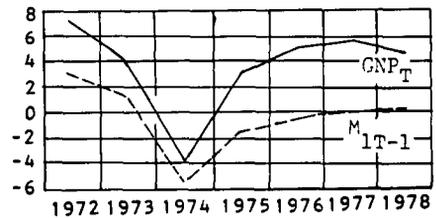


FIGURE VII-2
REAL GNP_T AND REAL MONEY_{T-1}
 (Rates of change, Q-iv to Q-iv^a)



A. United States



B. Europe - four largest countries

NOTE: The money base in the previous year, M_{T-1} , equals the nominal change in M_1 in the previous year divided by the rise in prices of the current year.

¹ Preliminary estimates for 1978.

SOURCE: Federal Reserve Bank of St. Louis: quarterly data.

but still not yet approved) incentive of “real wage insurance” via income tax reductions to workers accepting wage norms if inflation exceeds a predicted rate (7 percent).³

C. WORLD TRADE AND PAYMENTS IN GENERAL

In line with the roughly constant average world growth rate (the slight reduction in the United States rate and rise in that of Europe offsetting one another, and the developing countries maintaining their generally stronger pace), world trade continued to expand at about the rate of the previous year, 5 percent.

The US current account deficit remained large but stopped its fast rise. The stabilization of oil imports plus the gradual but real impact of previous dollar depreciation suggest a reduction in 1979. OPEC’s current surplus fell very sharply, (due to both reduced terms of trade and stagnant oil exports) to levels comparable with those attained before the great oil price rise of 1973 (about \$ 9 billion). The industrial countries collectively returned to their previous role as the major creditors (i.e. net capital exporters) to the (non-oil) developing nations – who remained in large and even growing current deficit.

³ Note further discussion below. The initial stimulus for this shift in priorities was the alarming plunge of the US dollar toward October 1978, and the measures adopted included more direct US exchange market intervention via borrowed reserves as well as pledges of demand restraint, etc.

TABLE VII-3
MEASURES OF FISCAL IMPACT, 1977 AND 1978

	Effect of change in direct tax on real private disposable income – Percent change ^a		Change in domestic fiscal balance as percent of GDP	
	1977	1978	1977	1978
	(percent)			
Canada	1.0	1.1	0.7	1.2
U.S.A.	-1.4	-1.1	-0.9	-0.6
Japan	0.3	0.0	0.3	2.3
France	-0.3	0.4	0.8	0.7
West Germany	-0.8	0.8	-0.6	0.5
Italy	0.1	1.0	0.1	0.6
U.K.	1.8	1.8	-1.1	0.5
4 major European countries	0.0	0.9	-0.2	0.6
Average of 7 countries	-0.6	-0.1	-0.4	0.3

^a Equals difference between change in gross private real disposable income and change in the same income less income and other direct taxes.

SOURCE: OECD, *Economic Outlook*, December 1978, Tables 5 and 12.

D. DEVELOPMENTS IN ISRAEL

In Israel the first signs of cyclical recovery, barely visible in late 1977, developed into a clear trend of faster real growth in both aggregate domestic demand and GNP. Thus 1978 represents the first year of significant growth since the onset of a declining trend during 1974. The recovery, however, was marked by somewhat less real growth and more price inflation than was generally anticipated, as well as a variety of speculative excesses (housing prices and foreign borrowing are two cases in point). Most of 1978 inflation (perhaps 40 percent) was, of course, pre-determined by the high ongoing cost-price spiral itself, which had been given a large recent stimulus by the steep devaluation of October 1977 and the resulting impact upon wage demands during 1978. However, the resurgence of real demand was superimposed upon this spiral, and added an extra fillip to inflation, especially toward the end of the year.

This combination of factors (steep average devaluation in late 1977, accelerated inflation and real growth during 1978) plus a swing toward monetary restraint from mid-year, set the stage for a major rise in capital imports late in 1978. The effect of this, in turn, in stabilizing the nominal exchange rate (in the face of higher inflation) and discouraging exports, led to new restrictions on foreign borrowing in January 1979.

TABLE VII-4

GROWTH OF ISRAEL'S EXPORT MARKETS, 1976-1978^a
(percent, annual rates)

	1976	1977	1978
<hr/>			
Weighted by total Israeli exports			
Developed countries	13.8	5.5	6.0
Other	11.9	6.3	4.3
Total	13.2	5.6	5.8
Weighted by Israeli export excl. diamonds			
Developed countries	15.1	4.3	5.4
Other	9.3	6.7	0.7 ^b
Total	12.8	4.8	4.3

^a Based on import growth in each country weighted by its share in commodity exports from Israel (1976 weights for 1976; 1977 weights for 1977 and 1978).

^b Based on very partial data. A sharp reversal (from growth to fall) of Iranian imports explains much of the change to 1978.

SOURCE: Import volume: OECD *Economic Outlook*, December 1977, IMF, "International Financial Statistics", UN, "Monthly Bulletin of Statistics"; Israel: Central Bureau of Statistics.

The developments described placed the continuation of the fledgling recovery in some jeopardy, and presented policy-makers with the challenge of adjusting policies so as to reduce inflationary pressures and expectations, without crushing growth between the anvil of rising costs and the hammer of restricted nominal demand.

2. MONETARY-FISCAL MIX IN THE INDUSTRIAL COUNTRIES

As in 1977, the direct contribution of fiscal policy to the development of demand growth was much more limited than that of monetary factors. A major direct source of monetary expansion (in both 1977 and 1978) was the recurrent effort to "defend" the dollar made by monetary authorities in both Europe and Japan. This tended to raise monetary growth rates both in these areas and, on the average, world-wide, because no offsetting contraction occurs in US monetary growth, (other monetary authorities typically reinvest the proceeds of their exchange market intervention in US bonds thus preventing any contraction in the US money base). These trends were at least consistent

in direction with the (moderately) expansionary intentions of the authorities in most countries.

It is quite likely, however, that they added something to the monetary growth which would otherwise have been achieved.

Table VII-3 summarizes two measures of fiscal impact. In general, these show a slightly positive stimulus, especially in Japan and in Europe, excluding France. In Europe this was usually in line with the direction of stimulus arising from money growth during the preceding year and with current changes in actual GNP growth. In Japan, however, monetary growth slowed during 1977, but, along with fiscal policy, turned strongly positive in 1978 – in line with pressure from the United States and other deficit trading partners for expansion of domestic demand. These stimuli, with their variable lags, appear to have moderately increased Japanese real domestic demand during 1978, and, together with a halt in export expansion (partly induced by a steep appreciation of the Yen), yielded a roughly unchanged rate of GNP growth. The sharp uprise in Japanese real money balances of 1978 could stimulate further real demand growth, since no sharp reversal of the fiscal-monetary instruments is expected during 1979.

3. TRADE, PAYMENTS AND EXCHANGE RATES

A. TRADE

As noted in the introduction, world trade continued its trend of 1977 (about 5 percent), consonant with the still sluggish growth of the industrial nations.⁴ The outstanding special developments in this field include:

1. **A steep shrinkage of the OPEC export surplus** (see Table VII-10). This resulted mainly from a halt in the expansion (and even a small reversal) of oil exports, (as the result of increased output in non-OPEC areas such as the North Sea and Alaska) and from a relative rise in the price of OPEC imports. Indeed, the real growth in OPEC imports also declined to pre-1974 levels (about 4 percent). For the first time since the 1973 oil price revolution OPEC countries experienced a significant fall in their terms of trade (about 10 percent according to IMF figures).

⁴ This figure is well below the level of 1976 or the exceptional boom years of 1971–1972, and compares with a trend of about 8–9 percent during the 1960's. In the last years (see Table VII-5) a better average performance by the developing countries has offset part of the weaker trend in the industrial world. This shift, however, has been to the disadvantage of Israeli exports (which are oriented toward the developed countries).

TABLE VII-5

SUMMARY OF CHANGES IN WORLD TRADE, 1975-1978
(Percent, annual rates)

	1975	1976	1977	1978
Volume of world trade	5.0	12.0	4.5	5.0
Volume of imports				
Industrial countries	-0.8	14.5	4.5	5.5
Other developed countries	-7.5	3.5	0.5	-0.5
Major oil exporters	42.0	19.0	14.0	4.5
Other developing countries	-6.5	4.0	5.0	7.5
Volume of exports				
Industrial countries	-4.5	11.0	4.0	5.2
Other developed countries	2.0	11.0	6.0	9.0
Major oil exporters	-11.0	14.5	0.0	-4.5
other developing countries	2.0	14.5	5.0	7.0

SOURCE: International Monetary Fund data.

As a result, the general breakdown of world trade balances returned to the pre-1974 pattern – a large deficit (and capital import) in the non-oil developing area, financed by a large surplus (and capital export) by the industrialized countries. This pattern is likely, however, to be partially reversed again in 1979 by the oil price hikes achieved both before and, especially, since the Iranian crisis.

2. The prolonged slide of the dollar. The fall of the exchange value of the dollar, particularly in relation to the currencies of the least inflationary industrial countries, such as Germany and Japan, which began in late 1977, continued until the end of October 1978. By this time the US currency had lost about 18 percent of its overall value (relative to a basket of foreign currencies) and as much as a quarter or a third of its value relative to the German mark and yen respectively.

The extent of this slide appears to have been both unanticipated and exaggerated by destabilizing speculation, judging by “fundamentals” such as relative internal inflation or the prospect for trade shifts resulting from earlier devaluations. The speculative fever was particularly evident toward the end of the period, especially in October itself, when the dollar lost 6.5 percent of its overall value, and it became clear that US firms and individuals were joining foreigners in a general flight from the currency.

At any rate, these movements provoked a series of strong measures by the US government to “defend” the dollar, including heavier exchange market intervention and a promised tightening of credit and money. The dollar promptly recovered lost ground in

TABLE VII-6

CHANGES IN CONSUMER PRICE INDICES: INDUSTRIAL COUNTRIES, 1976-1978
(Percent changes, at annual rates)

	1976	1977	1978	1978 ^a	
				1st half	2nd half
Canada	7.5	8.0	9.0	8.6	9.3
U.S.A.	5.8	6.5	7.7	7.7	9.1
Japan	9.3	8.1	3.8	3.7	3.0
France	9.6	9.8	9.3	8.2	10.5
Germany	4.5	3.9	2.6	2.5	2.2
Italy	16.3	17.0	12.1	12.6	11.7
U.K.	16.5	15.9	8.3	8.0	8.0
Total OECD	8.6	8.9	7.9	-	-

^a Compared to previous half.

SOURCE: 1976 and 1977 - OECD. *Economic Outlook*, December 1978. 1978 I and II, IMF data; data for 1978 as a whole - "National Institute Economic Review", February 1979.

November and closed the year with a net loss of about 12 percent from the start of its slide in the fourth quarter of 1977. This recovery was maintained and even strengthened during the first months of 1979.

TABLE VII-7

COMMODITY PRICES, 1974-1978^a
(Indexes: 100 = 1977, calculated according to price in dollars)

	1974	1975 ^a	1977		1978	1977 ^b	1978 ^b
	Peak	Trough	April	October	October		
All non-oil commodities	86.7(II)	71.4(IV)	110.4	94.6	101.9	20.4	-4.7
Beverages						73.0	-27.7
Food	86.2(IV)	63.1(IV)	116.2	91.0	94.5	-3.6	13.8
Agricultural raw materials	107.8 (I)	77.9(III)	103.5	96.7	111.8	3.3	7.6
Metals and minerals	113.4 (II)	86.8(III)	100.9	102.9	112.6	5.5	7.4

^a Parentheses show peak and trough quarters.

^b Percent change from previous year.

SOURCE: OECD, December 1978; 1977 and 1978, IMF data.

Perhaps the most serious consequence of this episode of relative disorder in the exchange markets was the prospect of a tightening of US monetary policy sufficient to drive the economy into a new recession (the US government was particularly concerned with the domestic inflationary impact of continued dollar depreciation, but also with the possible retreat to protective restriction which it could bring about in world trade). A recession in 1979 became indeed the "consensus" of private forecasters and commentators in the United States toward the close of the year, although official US forecasts were for a more moderate dip in growth. Even such international bodies as the OECD predicted a fall to 2 percent for 1979 as a whole and 1-1.25 during the year.

In the event, US monetary growth rates did slow abruptly in late 1978 and early 1979.⁵

TABLE VII-8

CHANGES IN WAGES, GNP PRICES AND EXPORT PRICES
IN 7 MAJOR COUNTRIES, 1977 AND 1978
(Percent)

	1977				1978			
	Hourly wage	GNP prices	Export Prices		Hourly wage	GNP prices	Export Prices	
			Local currency	SDR			Local currency	SDR
U.S.A.	8.5	5.9	4.8	3.7	8.5	7.5	9.3	1.8
Japan	9.5	5.5	-0.3	8.8	7.8	4.0	-3.7	14.5
West Germany	7.5	3.6	1.7	9.0	5.5	3.8	-1.1	6.7
France	12.7	8.7	9.9	5.7	13.3	9.8	5.5	7.2
U.K.	10.3	13.3	16.9	12.2	14.5	11.3	6.3	9.0
Canada	10.8	6.9	6.8	-2.1	7.5	6.8	8.7	-5.6
Italy	27.9	18.3	20.4	12.3	14.0	13.4	7.5	4.2
All above countries	10.1	6.9	5.8	4.6	9.3	7.0	4.9	5.9
Total OECD	10.2	7.4			9.0	7.3		

SOURCE: Wages and GNP prices - OECD December 1978, Tables 21, 25, and 52. Export prices - International Monetary Fund data.

⁵ Rising nominal interest rates during the first three quarters of 1978 were unaccompanied by any dip in monetary or credit growth, and hence, appear to have reflected the "demand pull" of growth in real GNP and rising inflation. This situation was reversed after October, with a continued rise in rates, but much less expansion of money and credit.

TABLE VII-9
GROWTH OF MONEY SUPPLY (M_1) 1976-1978
 (annual rates)

	IV 1976 to IV 1975	1977				IV 1977 to IV 1976	1978 ^a		In year to month shown (in parentheses)
		I	II	III	IV		I	II	
U.S.A	5.8	7.2	8.6	8.3	7.7	7.9	6.3	10.3	6.5 (12)
W. Germany	6.5	12.6	6.0	12.7	10.3	10.4	25.3	6.5	14 (12)
France	10.7	8.1	7.1	14.5	7.4	9.2	16.8		13 (11)
U.K.	10.3	13.4	15.9	29.5	29.7	21.9	17.3		14.5 (1)
Italy	20.6	21.7	22.4	20.1	17.6	20.4			23 (10)
Japan	14.7	4.2	-3.0	16.9	7.0	6.1	9.7	13.2	13.5 (1)
Netherlands	6.9	16.7	24.7	18.6	-0.7	14.4	1.6		4.5 (12)
Belgium	7.0	8.2	2.7	18.5	8.8	9.4	8.2		
Switzerland	8.0	6.7	2.7	0.1	-1.4	2.0	33.9		

^a There are only data for the first two quarters.

SOURCE: Quarterly data - Federal Reserve Bank of St. Louis, "International Economic Conditions". September, 1978; 1978 "in year to month shown (in parentheses)" - *The Economist*.

Nevertheless, the higher average monetary growth rates of the year as a whole made it quite unlikely that US GNP growth would slow as quickly as had been widely anticipated.⁶ Nevertheless, if the authorities persevere in the monetary policy described (and they have done so as of this writing in April 1979), this, plus the effect of higher recent rates of inflation on real cash balances, must sooner or later "justify" the predictions of recession.

The fate of the dollar, however, seems likely to be more favorable even without a US recession. The effects of previous depreciations are beginning to emerge and oil imports (a major source of the dollar's weakness) have already tended to stabilize in 1978. Another US recession would, of course, add further to the dollar's strength — but at very high cost, both inside the United States and, via trade, to the rest of the world.

TABLE VII-10
WORLD CURRENT ACCOUNT, 1977 AND 1978
(\$ billion)

	Incl. official transfers			Excl. official transfers		
	1977	1978	Increase or (—) decrease from previous year	1977	1978	Increase or (—) decrease from previous year
OECD	-27.5	-0.8	+26.7	-13.0	18.8	+31.8
OPEC	31.5	11.0	-20.5	33.5	12.5	-12.0
Non-oil developing countries	-24.0	-34.0	-10.0	-33.5	-44.5	-11.0
Other countries	-10.0	-10.8	-0.8	-10.0	-10.8	-0.8
World Total ^a	-30.0	-34.5	-4.5	-23.0	-24.0	-1.0

^a Differs from zero owing to errors, omissions, and asymmetries which, although fluctuating somewhat, are sufficiently stable to give a rough indication of yearly changes in regional balances.

SOURCE: OECD, December 1978, Table 33.

3. **A European Monetary System.** The excessive slide of the dollar (and even steeper rise of several other currencies) displayed an unfortunate weakness in the stability (and, possibly, even the rationality) of speculation in floating exchange markets. This probably helped to speed the renewed effort to form a European Monetary System ("EMS").

⁶ Relatively low rates of growth of M_2 over the year can be accounted for by interest rate increases which tended to shift demand toward large CDs and government securities which are not included in M_2 but are close substitutes for it.

The proposed system involves a combination of wider margins of fluctuations (4.5 percent) between each pair of currencies, and of narrower margins between each and a weighted average of all (i.e. against a new system unit of account and of settlement between central banks; the "ECU"). "Swaps" and central bank intervention are to keep currencies within their bilateral limits; more severe macro-economic measures, including possible changes of parities, are to be taken if they tend to breach their ECU limits.

The difficulties of any such system are great, given distinctly different patterns of inflation within western Europe. A successful link will probably require a more radical loss of local sovereignty in respect to monetary policy than is presently acceptable. Barring this, the system may amount to little more than a somewhat more "organized" form of adjustable peg. In fact, even this restricted system was held up (until March 1979) by disagreements connected with the complex EEC system of subsidies to agriculture via special "green" exchange rates. Nevertheless, we should not entirely discount the possibility that we are witnessing one step in the slow evolution of a unified European policy and a common currency.

4. THE ISRAELI ECONOMY

Economic developments in Israel vis-à-vis the world economy were dominated by the emergence, after a downtrend of three years, of a clear (albeit still moderate) recovery in real domestic demand. The growth rate of this aggregate rose from the +2 and +3 percent of recent years to about +4–5 percent. GNP growth rates also swung upward, but less steeply (from about +1 to 5 percent), because export expansion, strong during the recession, was somewhat blunted by several factors. These included the continued slow growth of world trade,⁷ a world-wide depression in the important diamond trade, and, to some degree, the revival of local demand itself.

Although weakened by the factors noted, the growth of Israeli exports and the fairly moderate expansion of imports of goods and services did reflect the influence of the steep average real devaluation which took place in October 1977 (at the time of reform and liberalization in the exchange system).⁸ This served to nearly offset the tendencies of the first year of cyclical expansion to increase the import surplus. In the course of the year,

⁷ Tables VII-4 and VII-5 provide some recent data on these points. Note that Israel's (non-diamond) market in the developing countries ("Other" in Table VII-4) already suffered because of an Iranian import recession prior to the upheaval of February 1979.

⁸ The fact that the devaluation was greater for imports suggests that import substitutes were encouraged more than exports.

TABLE VII-11

ISRAEL'S TERMS OF TRADE IMPACTS, QUARTERLY, 1977 AND 1978
(1973 = 100)^a

	1978				1977	1978	Excluding diamonds ^c	
	I	II	III	IV			1977	1978
	1. Index of goods import prices	186.5	196.6	199.2			210.2	164.4
2. Index of goods export prices	182.4	185.9	201.7	225.3	148.1	198.8	145.8	164.7
3. Terms of trade for goods	97.8	94.6	101.3	107.2	90.1	100.4	85.2	88.5
4. Percent change in (3) from 1973	-2.2	-5.4	1.3	7.2	-9.9	0.4	-14.8	-11.5
5. Terms of trade effect on national income (percent of GNP) ^b	-0.5	-1.2	0.3	1.6	-2.2	0.1	-3.3	-2.6
6. Changes in (5) from previous year						2.3		0.7
Addendum								
1) Terms of trade for goods and services (1973 = 100)					98.3	98.6		
2) Effect on national income ^c					-0.4	-0.3		
3) Change from previous year						+0.1		

^a Price data for trade in goods: Laspeyres indexes of the Central Bureau of Statistics.

^b Equals change in Terms of Trade from 1973 (row 4) multiplied by exports, as percent of GNP. This constitutes the approximate cumulative impact of terms of trade changes from 1973 on the real national income, and, directly, on the imports obtainable from constant real exports.

^c Calculated in a manner corresponding to (5). Service import and export prices, based upon National Accounts data, are less reliable than those for goods.

especially in the last quarter and early 1979, heightened price inflation,⁹ combined with large capital imports and a fairly stable IL exchange rate, tended to erode this balance, leading towards an increase in the current account deficit.

The course of the IL exchange rate over the whole year and its near stability towards yearend is shown in Table VII-12. In explaining this course, it is interesting to note, firstly, that relative to the currencies of our trading partners (15 currencies weighted by Israeli exports or imports). IL devaluation nearly offset our relative inflation during the year, especially up to October.¹⁰ The initial sharp devaluation of October 1977 began the float at a relatively high level especially for imports and capital flows. Thus, as previously noted, the expansive effect of the recovery upon the current deficit did not yet fully express itself (apart from defense imports). Capital imports began to be stimulated by improved expectations for investment based upon the recovery of demand growth itself. But, in the short run, they were more sharply affected by a severe tightening of money and credit after midyear. (For example, M_1 grew at an annual rate of over 40 percent from December 1977 to June and barely at all from June to October – a major slowdown may also be observed in M_1 + "Patam" or in IL credit expansion.) The latter factor led to a massive substitution of foreign for domestic credit sources. This, in turn, slowed the pace of IL depreciation relatively to the rate of inflation, and thereby probably (in an example of destabilizing speculation) tended to increase capital imports still further. Whatever the role of speculation, the process described culminated in a torrential inflow in December, clearly stimulated by the anticipation of new restrictions (which had been suggested in official circles during the preceding weeks). The great bulk of this inflow was accumulated (initially at least) in Patam accounts. In the event, restrictions did come in late December and in February 1979, stopping the inflows.

This episode may prove beneficial in providing lessons in the problems inherent in the operation of a convertible floating currency. These include the fact that fluctuations in the supply of domestic money and credit and related changes in domestic interest rates, should be very moderate, unless one is prepared (in the case of deflationary policy) to allow the deflection (in slowdown) to operate partly through a falling real exchange rate

⁹ Stimulated by both wage reactions to the earlier devaluations and by a relatively inelastic supply of additional labor (although unutilized capital was abundant). See Chapter X, "Prices", for a more detailed discussion.

¹⁰ Publically this fact was often overlooked, due to concentration upon the much smaller rise of the IL/\$ rate. Table VII-12 shows the devaluations of the lira against 15 currencies, against the basket of 5 currencies used during the earlier "mini-devaluation" system and against the dollar. The Table reveals the impressive effect of the fall in the \$ vis-à-vis other currencies in differentiating these comparisons.

and a consequent temporary reduction in the profitability of "tradeable" goods (exports and import substitutes) – relying on the offsetting temporary fluctuation in capital imports to balance overall payments.¹¹

5. ISRAELI TERMS OF TRADE AND SPECIAL FACTORS

Table VII-11 (slightly revised from previous years) provides an overview of the terms of trade during 1978. These were marked by some sharp inequalities. While diamond terms of trade (and hence goods including diamonds) rose sharply, this improvement is not visible in either "goods excluding diamonds" or in the overall terms of trade for all goods

TABLE VII-12

CHANGES IN THE EXCHANGE RATE OF THE IL, 1978 (various concepts, percent)

	IL compared to 15 currencies		IL compared to basket of 5 currencies	IL compared to \$
	Weighted by imports	Weighted by exports		
January	4.2	4.1	5.5	2.8
February	3.3	3.3	2.1	1.8
March	2.6	2.9	2.9	1.8
April	1.1	1.6	0.4	1.3
May	1.0	0.8	1.2	2.7
June	3.9	4.5	2.9	3.1
July	4.4	4.7	3.9	2.4
August	4.0	4.4	3.3	1.6
September	2.0	2.2	0.9	0.8
October	3.2	3.4	3.9	0.0
November	-0.5	-0.8	-0.2	2.2
December	0.5	0.2	0.4	0.0
During 1978	34.5	36.2	30.9	22.4

SOURCE: Bank of Israel data, monthly figures equal average of daily quotations.

¹¹ Another implication is the need for greater flexibility in interest rates on linked government securities, so that they can fall against, and thus resist, a surge of capital imports stimulated by expectations of high inflation and low rates of depreciation.

and services. The largest offsetting change in the latter appears to have been in travel and tourist services, in which (in classic fashion) our steep real devaluation in October 1977 held our \$ prices rather stable while those of imported services rose fairly rapidly. The special situation in diamonds may indeed have saved us from an overall loss due to this tendency.

Apart from the currency aberrations described, several other factors affecting Israeli exports deserve notice. Citrus exports dipped noticeably due both to the "mercury scare" in Europe and local port strikes. While diamond exports were held very high in price on world markets by the main suppliers of raw diamonds, their quantity fell sharply — presumably as a consequence of the higher prices, plus a universal tendency toward speculative stockpiling during 1977 and discarding during 1978. Finally, it is interesting that the liberalization of October 1977 completely abolished currency exchanges on the black market, and thus the distortion which existed in exports of tourism services.¹²

¹² The series of this item for recent years were corrected to overcome this distortion. (See above, Chapter V.)