

## CHAPTER VII

### ISRAEL AND THE WORLD ECONOMY

#### 1. MAIN DEVELOPMENTS

The economic recovery from the deep world recession of 1974-75 continued at a steady and fairly strong pace in the United States in 1977, and at a steady but low rate relative to potential growth in Japan. In Europe, however, after one year of significant progress in 1976, the recovery faltered, and even went seriously into reverse. Output growth fell to less than half that of the previous year and both unemployment and unutilized capacity increased. By contrast, average growth was steady for less industrialized economies (which have been more stable than the industrialized throughout the world recession).

Analysis of the difference in developments in America and Europe makes it clear that it primarily reflects the difference in monetary expansion over the preceding year – steady growth in the United States versus a severe tightening in Europe (which has again been reversed in the course of 1977). Restrictive policies in some European countries, intended to combat inflation and payment deficits, produced a greater collective effect than was anticipated. Given the reversal of this trend, the prospect is for a renewal of meaningful cyclical recovery during 1978.

In Europe price and wage inflation yielded marginally to the fall in demand growth together with the impact (especially in the United Kingdom) of incomes policy. In both Europe and America, after a rise in early 1977, mainly due to some food shortages (notably, coffee) and to a small extent, some speculative commodity buying, inflation fell during the year. Lower average rates are expected for 1978. In the United States the average rate of inflation, like growth, remained practically unchanged (at about 6 percent) and there seems little prospect of change in 1978.

In line with the slowdown in GNP growth, the growth rate of world trade fell sharply (from about 11 to the area of 3 to 5 percent)<sup>1</sup>. Weighted by Israeli exports, market growth was rather higher than world averages in both 1976 and 1977.

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<sup>1</sup> The U.K. National Institute is the source of the 3 percent figure. It appears to be based on an extrapolation of the flat level of trade in the first half of 1977. The March 1978 IMF estimate is 5 percent.

TABLE VII-1

**GROWTH OF REAL GNP IN OECD COUNTRIES, 1964-1977**  
(percent change at annual rate)

	1964/65			1976	1977	
	to 1974/75	1976	1977	2nd half	1st half	2nd half
Canada	5.2	4.9	2.6	0.0	2.8	3.4
U.S.A.	3.0	6.0	4.9	3.5	5.6	5.0
Japan	8.6	6.3	5.1	3.0	7.6	3.6
France	5.0	5.2	2.7	3.5	3.0	1.4
W. Germany	3.6	5.7	2.5	2.9	3.1	0.9
Italy	4.6	5.6	1.7	3.8	2.2	-1.4
U.K.	2.3	2.1	0.0	1.6	-1.8	1.6
4 principal European countries	3.9	4.9	2.0	3.0	2.0	1.7
Total above countries:						
Weighted by OECD	4.3	5.6	3.9	3.1	4.6	3.6
Weighted by Israel's exports <sup>a</sup>	3.5	5.2	3.2	2.9	3.5	3.1
Other OECD countries	4.5	2.9	1.5	3.2	1.1	0.5
Total OECD	4.3	5.2	3.5	3.1	4.0	3.3

<sup>a</sup> Weights according to total export of commodities.

SOURCE: *Economic Outlook*, December 1977, OECD, and IMF data.

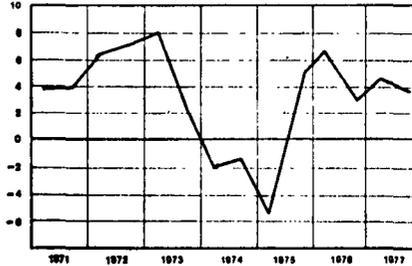
The United States import surplus greatly expanded in 1977 in line both with its higher growth rate and increased dependence upon imported oil. This, and particularly the latter factor, underlay the weakening of the dollar late in the year and in early 1978. Required oil imports however, are likely to stabilize in 1978 and over the next few years, if only because of the "maturing" output of new Alaskan fields.

In Israel during 1977 there was apparently a slight recovery in the trend of domestic demand, following the fall in the previous year. The impact of the slowdown in market growth abroad however held back somewhat a corresponding reversal of the overall GNP growth trend.

Toward the end of the year the economy entered into a new era of major exchange system reforms. An unfortunate immediate effect was an additional jolt of cost push inflation (due to a large effective devaluation with respect to imports), but the more favorable effects (i.e. encouragement of capital import and aliyah, better resource allocation, and less distortion) are not of an immediate kind, and remain to be seen.

A notable "special event" of the year was a sharp but transitory rise in overall terms of trade, concentrated within the diamond trade. This was exploited for an extraordinary surge of investment in diamond inventories, the unwinding of which should significantly reduce Israel's current deficit (probably during 1978).

**FIGURE VII-1**  
**REAL GNP GROWTH RATE**  
**SEVEN MAJOR OECD COUNTRIES**  
**1971-1977**  
 Percent Change - Half Years at Annual Rates



SOURCE: OECD.

## 2. DEMAND AND GROWTH IN THE INDUSTRIALIZED WORLD

The primary economic fact of 1977 was the retrogression in Europe of the recovery from the 1974-75 world recession. In the United States and Japan recovery and growth continued at nearly the pace of the previous year. In Europe, year-to-year growth fell to less than half that of 1976 (with still less growth during the year itself). This left actual growth well below potential, with a clear rise in unutilized capacity and unemployment<sup>2</sup>.

<sup>2</sup> Tables VII-1 and VII-2 provide data on these points. It should be noted that, with exceptions, the smaller European countries achieved even slower growth than the larger. Usually (eg. in Sweden) this reflected an attempt to curb higher inflation rates and to avoid significant currency devaluations vis-a-vis the main currencies (especially the German mark). This factor (higher inflation), rather than earlier higher growth rates, was the essential factor destabilizing exchange rates, although, of course, stronger recovery in the large economies would have eased (or avoided) the problems of the smaller in financing the current deficits entailed by relatively high growth rates.

TABLE VII-2

**UTILIZATION OF PRODUCTION CAPACITY AND UNEMPLOYMENT,  
1964-1973, 1976 and 1977**

	Rate of utilization of industrial production capacity			Rate of unemployment <sup>a</sup>		
	Average 1964-1973	1976 IV	1977 III	1976 IV	1977 III	1977 IV
U.S.A.	85.4	80.6	83.0	7.7	6.9	6.7
Japan	95.9	87.2	85.4	(2.0)	(2.2)	(2.1)
Germany	86.3	82.6	81.7	(3.4)	(3.5)	(3.5)
France	82.1	80.4	-	(4.6)	(5.7)	(5.1)
U.K. <sup>b</sup>	45.3	31.0	32.0	(6.9)	(8.1)	(8.2)
Italy	78.5	75.6	71.6	(6.6)	(7.9)	(8.2)
Average of 4 European countries	76.4	71.4	66.7	4.9	5.8	5.5

<sup>a</sup> Figures in parentheses have been adjusted by OECD to common definition (identical to the American definition).

<sup>b</sup> Percent of companies operating at full production capacity.

SOURCE: OECD.

### 3. CYCLICAL CHANGES AND POLICIES

Examination of the contributions of monetary and fiscal factors leaves little doubt that the contrast between stable growth in the United States and the slowdown in Europe was primarily the consequence of a parallel difference between the leading expansion of the money supply in the two regions – stable growth in the United States versus a major reduction in Europe during the preceding year (1976). Table VII-9 shows the nominal figures and Figure VIII-2 the real money growth rates. By contrast, fiscal policy (which affects aggregate demand with a shorter delay) was tightened in both Europe and the United States in 1976, and was essentially unchanged in 1977 (and even slightly depressive). Table VIII-3 reveals this fact quite clearly.

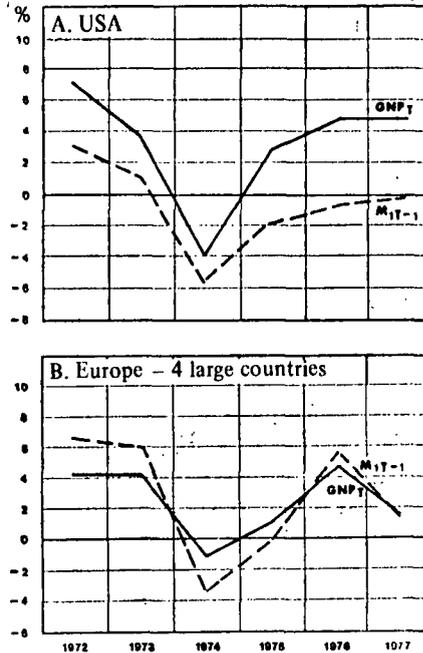
It is noteworthy that in 1977 European growth fell below expectations (e.g. suggested by the OECD, the IMF, and national forecasts in late 1976). This apparently reflects a

tendency to underestimate the collective effects of individual country restraint policies, and particularly the extent of the lagged impact of changes in monetary growth rates upon output. The latter tendency is also suggested by the sharp fluctuations of average monetary growth rates (e.g. from 15 percent in 1975 to 10 percent in 1976 to about 14 percent in 1977 for the 4 largest countries)<sup>3</sup>.

Diagram VII-2 shows the close correlation in both Europe and the United States between real GNP growth in a given year and real monetary growth in the preceding year. The data of Table VII-9 show that the reduction of the real money growth rate in Europe during 1976 (mainly affecting 1977) came from a direct reduction in the nominal monetary growth rate, rather than from a sharp rise in prices, as occurred, for example, in 1974. Since the price inflation trend (about 9.5 percent, including wage-price spiral) is resistant to demand pressures, the great bulk of the decline in nominal demand growth in the shorter run (i.e. in 1977) necessarily took the form of a reduction in real demand, and thus in real GNP, growth rates<sup>4</sup>. The price inflation trend, however, is not entirely impervious to pressures created by the weakening of both labor and product

FIGURE VII-2

**REAL GNP<sub>T</sub> AND REAL MONEY<sub>T-1</sub>**  
(rates of change, Q-iv to Q-iv)



SOURCE: Federal Reserve Bank of St. Louis: quarterly data. "M<sub>1T-1</sub>" equals nominal monetary change of previous year/price change of current year.

<sup>3</sup> Hypothetically, tighter monetary growth might have been combined with more fiscal stimulae in order to obtain continued recovery while strengthening external balances through the attraction of short-term capital imports. However the European data do not suggest such a policy orientation. The two instruments (monetary and fiscal policy) tended if anything, to move in a complementary rather than offsetting direction.

<sup>4</sup> In line with the analysis of the text, a better "fit" is obtained when the nominal money changes of the previous year are deflated by the price changes of the current year. This is the procedure followed in Figure VII-2. The vertical distance between the GNP and money growth curves in the US (Figure VII-2) reflects a strong secular trend toward rising velocity (more transactions per dollar of M<sub>1</sub>). This trend is not evident in Europe. Hence the lack of such a gap in the European diagram.

TABLE VII-3

## MEASURES OF FISCAL IMPACT, 1975-1977

	Effect of change in direct tax on real private disposable <sup>a</sup> income - Percent change			Change in domestic fiscal balance <sup>b</sup> as percent of GDP		
	1975	1976	1977	1975	1976	1977
Canada	1.7	-0.9	0.6	3.1	-0.8	0.8
U.S.A.	3.7	-1.2	-1.4	2.7	-1.9	-1.1
Japan	2.0	1.1	0.0	3.5	0.6	0.2
France	1.1	-1.3	-0.2	1.9	0.1	0.5
West Germany	4.9	-1.9	-0.9	2.5	-1.2	-0.4
Italy	2.9	-1.6	-2.2	4.9	-2.3	-1.3
U.K.	-3.7	0.3	1.9	-0.2	0.1	-0.7
4 principal European countries	1.0	-1.3	-0.4	2.5	-1.1	-0.5
Total	2.7	-0.9	-0.7	2.3	-0.7	-0.3

<sup>a</sup> Equals difference between change in gross private real disposable income and change in the same income less income and other direct taxes.

<sup>b</sup> Calculated according to changes in real government expenditure and in revenues from taxes (i.e. in government demand surplus) expressed as percent of the Gross Domestic Product of the previous year.

SOURCE: OECD, *Economic Outlook*, December 1977.

markets, and so inflation did fall moderately in later 1977 and is likely to be lower on average in 1978<sup>5</sup>. Moreover a large part, if not the bulk, of the overall reduction in inflation in Europe resulted from an unusually successful application of incomes policy in the United Kingdom. Wage increases there were held well below consumer price inflation – preparing the ground for a rapid and stable fall in price inflation in the latter months of 1977 and in 1978. Certainly demand restraint assisted this achievement, but, by contrast, a similar degree of demand restraint in Italy, for example, was not accompanied by a similar reduction in wage rises. Thus the slowing of Italian inflation brought by demand pressure in the second half of 1977 is unlikely to persist as demand revives (a point already confirmed by the most recent data).

<sup>5</sup> See discussion below of commodity prices.

TABLE VII-4

GROWTH IN ISRAEL'S EXPORT MARKETS, 1975-1977<sup>a</sup>

	1975	1976	1977
Weighted by total Israeli export			
Developed countries	-8.8	13.8	6.4
Other	11.7	11.9	7.6
Total	-2.5	13.2	6.8
Weighted by Israeli export except diamonds			
Developed countries	-8.3	15.1	6.5
Other	17.3	9.3	6.3
Total	0.4	12.8	6.4

<sup>a</sup> Based on import growth in each country weighted by its share in commodity exports from Israel (1974 weights for 1975; 1976 weights for 1976 and 1977). The developed countries: U.K., U.S.A., Japan, Italy, Belgium-Luxembourg, Germany, Netherlands, France, Canada, Denmark, Norway, Sweden, Switzerland, Austria, South Africa; "Other" includes: Iran, Hong Kong, Singapore, Spain, Nigeria (based on specific data for each country) and a remainder based on IMF estimates of average import growth for non-oil developing countries.

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

## 4. COMMODITY PRICES AND INFLATION

A major question lurking behind the slow and rather anxious recovery from the world recession is the behavior of "commodity" prices. The boom in these prices in 1973 and 1974, in addition to the escalation by OPEC of oil prices, set off the recession itself and, without doubt, fear of a similar rise inhibits a more determined effort at aggregate demand recovery. Commodity prices are the central "threat" because in the main they respond flexibly to demand conditions; falling below trend in a slump and rising above trend as world demand approaches capacity output. The possibility exists that, as capacity output is approached, these prices will rise at an exceptional rate in the short run — that is, until output capacity in "commodity" industries and substitution effects have adjusted the world economy to the full employment level and trend of world demand.

These are general possibilities. In practice early 1977 witnessed a sharp increase in the average level of food commodity prices — but this was clearly the result, not of cyclical

TABLE VII-5  
**SUMMARY OF CHANGES IN WORLD TRADE, 1974-1977**  
 (Percent)

	1974	1975	1976	1977
Volume of world trade	5.0	-4.5	12.0	15.0
Volume of imports				
Industrial countries	1.0	-7.5	14.5	5.0
Other developed countries	6.0	-7.5	4.5	3.0
Principal Oil Exporters	39.0	42.0	18.0	15.0
Other developing countries	8.0	5.0	9.0	5.5
Volume of exports				
Industrial countries	7.5	-4.5	10.5	5.0
Other developed countries	1.0	-	12.5	5.0
Principal Oil Exporters	-1.0	-11.5	14.0	1.0
Other developing countries	3.5	0.5	14.0	6.5

SOURCE: International Monetary Fund data.

recovery, but of "accidents" reducing the supply of a few important items, especially coffee and other "tropical beverages." Table VII-7 shows that, aside from this, there was only a slight upward surge in early 1977 in raw material commodity prices. This indeed may have been associated with faster cyclical recovery during 1976, and the arrest of this price rise in the second half of 1977, with the renewed cyclical weakness (especially in Europe) during 1977. Finally, to the 1977 record we should add the judgment of various commodity experts (at the OECD, IMF and elsewhere). Neither suggests that commodity prices threaten an inflationary reaction to continued recovery, at least in the short run<sup>6</sup>.

<sup>6</sup> It should be noted however that while the United States' cyclical recovery was about three-quarters complete by early 1978, those of Europe and Japan were well below the half-way mark. On the other hand, as the U.K. National Institute brings out explicitly, the "expert" forecasts imply an actual reduction of commodity prices in 1978 after the rise in 1977 (National Institute estimates are -5.5 percent vs. 21.3 percent).

TABLE VII-6

**CHANGES IN CONSUMER PRICE INDICES: INDUSTRIAL COUNTRIES, 1974-1977**  
(Percent changes at annual rates)

	1974	1975	1976	1977	
				1st half	2nd half
Canada	10.8	10.8	7.5	8.5	9.4
U.S.A.	11.0	9.2	5.7	7.3	5.9
Japan	24.5	11.3	9.3	10.0	4.3
France	14.0	11.8	9.2	9.0	10.1
Germany	7.0	6.0	4.5	4.2	3.4
Italy	19.1	17.0	16.8	22.3	13.2
U.K.	16.0	24.2	16.6	20.5	9.2
Industrial countries <sup>a</sup>	13.2	9.9	7.9	9.0	6.3

a Including above seven and other countries.

SOURCE: International Monetary Fund data.

##### 5. INVESTMENT AND THE MONETARY-FISCAL MIX

The most widely discussed weakness of the world recovery was capital expenditure. The main cause for sluggish growth here was simply the failure of final demands to raise capital utilization to cyclically high levels. But, for the rest, although much attention was directed to such fashionable, partly real problems as ecological resistance and uncertainty about energy or cyclical prospects, a straight-forward cause was widely overlooked. This was the sharply altered monetary-fiscal mix which has persisted since 1974. Specifically, calculations indicate that even cyclically adjusted increases in public sector deficits (reductions in saving) in the industrial countries since 1974 have more than offset the increase in the world supply of saving made available by the increased current account surplus (and corresponding capital export) of the OPEC bloc.

While this increase in public sector dissaving was a convenient way of diminishing the direct impact of the OPEC surplus upon private wages and income, it arose to a larger

TABLE VII-7

## COMMODITY PRICES, 1974-1977

(Indexes: 100 = 1976; calculated according to price in dollars)

	1974 <sup>a</sup>	1975 <sup>a</sup>	1976	1977	
	Peak	Trough	Average	April	October
Total, excl. oil	(I) 109	(IV) 89	100	135	118
Food	(IV) 124	(IV) 91	100	160	129
Agricultural raw materials	(I) 108	(III) 78	100	111	104
Metals and minerals	(II) 122	(III) 93	100	108	109
Oil (OPEC)			100	108 (average)	

<sup>a</sup> Parentheses show peak and trough quarters.SOURCE: OECD, *Economic Outlook*, December 1977.

extent from a reluctance to combat the post-1973 recession through monetary stimulus<sup>7</sup>, and a resulting shift (during 1974 and 1975) toward reliance upon fiscal stimulus. Since, however, the effect of a fiscal stimulus (i.e. an increase in the fiscal deficit or demand surplus of the public sector) is transitory, the continuation of tight or neutral monetary growth, has tended to motivate its repetition, or at least to prevent the deliberate reduction of fiscal deficits.

## THE LESS DEVELOPED COUNTRIES

Economic growth in the world outside the OECD has provided a relatively stable background to the synchronized cyclical twists and turns of the major OECD economies (and thus has been able to provide some degree of ballast for the latter). In effect, the sharp fluctuations in growth of Europe, North America and Japan (and especially of the largest of the European economies) have produced dampened reflections in the economies of the primary producing areas most closely associated with each. Thus, while average growth for the non-oil "LDCs" as a whole maintained a remarkable degree of stability (falling, ac-

<sup>7</sup> We might explain this reluctance by noting that the onset of the recession was accompanied by (actually was precipitated by) an extraordinary, mainly cost-based, surge of price inflation. Such inflation is, however, traditionally associated with high rates of monetary growth. In addition, it was widely felt that an anti-recession policy mix involving tight money and higher interest rates would avoid (through capital inflows) expanding already unconventional payments deficits. In the event, the fiscal stimulus supplied proved inadequate for recovery but more than sufficient to offset the injection of the OPEC surplus into the world savings and capital supply.

TABLE VII-8

**CHANGES IN WAGES, GNP PRICES AND EXPORT PRICES  
IN 7 MAJOR COUNTRIES, 1976 AND 1977  
(Percent)**

	1976				1977			
	Hourly wage	GNP prices	Export Prices		Hourly wage	GNP prices	Export Prices	
			Local currency	SDR			Local currency	SDR
U.S.A.	7.9	5.3	3.4	8.7	3.0	5.5	4.5	3.4
Japan	12.6	6.4	-2.0	3.4	10.0	6.3	3.9	13.4
West Germany	6.5	3.3	1.9	4.7	7.5	3.6	1.5	8.8
France	14.7	9.6	9.1	2.8	12.8	9.3	10.4	6.2
U. K.	16.6	15.2	19.1	1.7	10.0	15.4	17.0	12.2
Canada	13.8	9.5	2.1	10.6	10.0	6.5	6.7	-2.1
Italy	21.1	17.8	20.6	-0.5	26.0	19.5	21.3	13.0
All above countries	10.5	7.0	4.6	6.1	10.4	7.1	6.3	6.6

SOURCE: Hourly wage – OECD, *Economic Outlook*, December 1977. Product and Export Prices. (Unit Value indices) – International Monetary Fund data.

According to IMF data, from 4.8 to 4.7 percent from 1976 to 1977), in Africa, which is especially oriented to Europe, growth rates fell significantly (from 4.7 to 2.9 percent). Latin America and Asia, both more oriented to the United States and Japanese trade, or characterized by successful internal development policies, actually increased slightly their already high growth rate (from 5.8 to 6.0 percent). Total GNP growth of the oil exporters (i.e. OPEC countries) experienced a sharp setback with the slower growth of oil imports of the OECD, but their non-oil economic sector continued a rapid expansion (at 10-11 percent per annum).

The non-oil LDC's as a group experienced little difficulty in financing their continued trade deficits in 1977. The problem was lightened somewhat by the fact that both the volume and price of their exports expanded faster than the volume and price of their imports, and faster than GNP growth in the industrial countries, their chief export markets<sup>8</sup>.

<sup>8</sup> The implied rise in the terms of trade partly reflects the surge in commodity prices (especially tropical beverages) described in Table VII-7.

TABLE VII-9  
**GROWTH OF MONEY SUPPLY (M<sub>1</sub>) IN SELECTED COUNTRIES, 1976 AND 1977**  
 (annual rates)

	IV 1974 to IV 1975	1976				IV 1975 to IV 1976	1977				In year to month shown (in parentheses)
		I	II	III	IV		I	II	III	IV	
U.S.A	4.4	2.9	8.5	4.4	6.7	5.6	4.3	8.7	9.7	7.0	7.5 (12)
W. Germany	16.5	6.6	11.5	8.5	0.2	6.6	11.9	6.2	15.6		11.5 (12)
France	13.1	18.8	10.7	13.5	0.5	10.7	9.3	5.6	17.8		8.0 (11)
U.K.	19.0	15.7	9.7	22.2	-4.1	10.4	13.4	15.9	29.5		20.0 (12)
Italy	10.9	34.1	21.4	12.4	15.6	20.6	25.7	25.2	17.1		19.0 (11)
Japan	10.9	24.2	9.4	14.9	11.3	14.8	2.8	-4.9	19.3		7.0 (1)
Netherlands	21.1	17.0	4.2	-12.7	21.7	6.7	16.9	26.3	16.0		14.0 (11)
Belgium	13.9	2.1	12.7	5.7	7.8	7.0	7.7	2.0	20.3		
Switzerland	3.9	12.6	5.3	5.2	9.1	8.0	7.0	3.0	-1.7		
4 Large European countries	15.2				9.1	10.5					

SOURCE: Quarterly data - Federal Reserve Bank of St. Louis; "In year to month shown (in parentheses)" - "The Economist".

TABLE VII-10

**WORLD CURRENT ACCOUNT, 1976 AND 1977**  
(\$ billion)

	Incl.official transfers			Excl. official transfers		
	Increase or (-) decrease from previous year	1977	1976	Increase or (-) decrease from previous year	1977	1976
OECD	-5.5	-32	-26.5	-5.0	-18.3	-13.3
OPEC	-2.3	40	42.3	-1.8	42.5	44.3
Non-oil developing countries	3.8	-22.5	-26.3	3.3	-33.5	-36.8
Other countries	2.0	-11.3	-13.3	2.0	-10.8	-12.8
World Total <sup>a</sup>	2.0	-25.8	-23.8	-1.5	-20.0	-18.5

<sup>a</sup> 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, *Economic Outlook*, December 1977.

#### 7. TRADE AND PAYMENTS - OUTSTANDING DEVELOPMENTS

The overall current account deficit of the industrial group, and of the developing countries too, vis-a-vis OPEC remained roughly unchanged. However, this marked a sharp rise in the current United States deficit together with a fall in that of Europe – both events a consistent reflection of their contrasting cyclical performances – but influenced by other factors as well.

This brings us to another of the more widely noted developments of 1977 (continuing into 1978), the decline of the dollar. This phenomenon reflected the impact of two forces, but primarily the latter: faster cyclical recovery, and a growing structural or secular dependence on imported oil, in effect, a decline in American terms of trade or underlying competitiveness. This trend is not necessarily permanent and, indeed, will probably be arrested in 1978 by a large increase in the expected “throughput” of the new Trans-Alaska pipeline, but it has been present over the last several years (a period of slow decline in United States petroleum output). Through 1976 its effect was largely offset by the deep recession, but in 1977 it appeared distinctly for the first time under conditions of substantial cyclical recovery.

TABLE VII-11

**US BALANCE OF PAYMENTS – AND OIL – 1974–1977**  
 (\$ BILLION)

	1974	1975	1976	1977	
				I-III	IV
Current Balance	-0.6	11.7	-1.4	-15.7	-7.0
Capital Balance <sup>a</sup>	-7.8	-16.3	-7.3	-2.0	-7.1
Balance on Official Settlements <sup>b</sup>	-8.4	-4.6	-8.7	-17.7	-14.1
Of which, OPEC		(-6.5)	(-7.6)	(-5.8)	(-1.0)
Memo items:					
A) U.S.A. Oil Imports (million barrels/day)	6.2	6.1	7.3		8.9
B) Increase in the cost of imported oil (Billion \$)	18.0	0.3	7.5		10.8

<sup>a</sup> Including capital flows of commercial banks and errors and omissions.

<sup>b</sup> Equals the net absorption of dollar assets by governments and central banks, including those of OPEC.

SOURCE: OECD *Economic Outlook* – various issues and International Monetary Fund data.

That the growing United States oil deficit precipitated the dollar's weakness<sup>9</sup> is most simply seen in the contrast between 1977 and earlier periods in which recovery in the United States has outpaced developments elsewhere. As a rule sufficient additional capital imports have been attracted to offset the cyclical fall in the current balance (at unchanged exchange rates). That the capital attracted was not sufficient in 1977 (despite the normal associated upswing of relative United States/Europe interest rates) implies the presence of an additional factor – the increased requirement for foreign oil – which could only be balanced by a devaluation and reduction of United States terms of trade (reflected in mea-

<sup>9</sup> This refers to the average fall in the dollar's exchange value. The sharper rise in such currencies as the DM and Swiss Franc reflect in large part the substantially lower inflation trends of their economies.

TABLE VII-12

**ISRAEL'S TERMS OF TRADE IMPACTS, QUARTERLY, 1976 AND 1977**  
(Laspeyres indexes, 1973 = 100)

	1977				1976	1977	Addendum Excluding diamonds <sup>c</sup>	
	I	II	III	IV			1976	1977
1. Index of goods import prices	158.8	163.1	165.7	170.0	151.0	164.4	158.4	171.1
2. Index of goods export prices	134.4	146.1	151.0	160.1	125.3	148.1	135.5	145.8
3. Terms of trade	84.6	89.6	91.7	94.2	83.0	90.1	85.5	85.2
4. Percent change in (3) from 1973	-15.4	-10.4	-8.3	-5.8	-17.0	-8.9	-14.5	-14.8
5. Terms of trade "import effect" <sup>a</sup> as a percent of:								
Domestic uses	-6.3	-4.2	-3.4	-2.4	-6.9	-4.0	-5.9	-6.0
GNP	-8.6	-5.8	-4.6	-3.2	-9.5	-5.5	-8.1	-8.3
6. Terms of trade effect on national income (percent of GNP) <sup>b</sup>	-3.4	-2.3	-1.8	-1.3	-3.8	-2.2	-3.2	-3.3
7. Changes in (6) from previous year					0.5	1.6		-0.1

<sup>a</sup> Equals change in terms of trade from 1973 (line 4) multiplied by imports, as percent of GNP and total domestic uses. Implies the obtainable change in imports if the change in purchasing power of export earnings determined the entire change in imports (including the part financed by capital imports).

<sup>b</sup> Equals change in terms of trade from 1973 (line 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.

<sup>c</sup> The data in these columns show that the large terms of trade impacts of 1977 stem almost entirely from a (temporary) increase in diamond export over import prices. Excluding this, there was no appreciable change in terms of trade.

sured terms of trade for 1977)<sup>10</sup>. Indeed it is quite possible that, even in the event of a faster recovery in Europe which would have sharply reduced the United States current deficit (but not oil imports), some real devaluation of the dollar would still have been forthcoming – until the United States stabilizes or reverses its shift toward foreign oil (temporarily, at least in 1978 and for several subsequent years because of Alaskan output).

The dollar's decline in late 1977 and early 1978 may have been exaggerated by the speculative flow which was clearly stimulated during the period. In any case, our analysis implies that it is unlikely to go much further for the time being. It may even be partially reversed by adjustments to the recent fall.

## 8. OTHER DEVELOPMENTS

For the most part, other developments in the field of trade and payments were not dramatic. Interest rates internationally reflected divergent cyclical pressures and counter-cyclical monetary policies, falling in Europe (where, as noted, 1977 monetary growth was accelerated to combat the slowdown in product growth), and rising in the United States<sup>11</sup>. Terms of trade showed no very significant change internationally, but in Israel responded, no doubt temporarily, to a dramatic special situation in the diamond industry (discussed below).

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Major developments were essentially independent of those internationally, as in 1976. But, on close scrutiny, some similarities and of course, some influences can be discerned.

Thus, the rate of change in domestic real demand (i.e. domestic "uses" equal to private and public consumption and investment, excluding defense imports) passed its trough in

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<sup>10</sup> Table VII-11 presents data supporting these statements. We see there that, while the United States net capital balance rose by about \$16 billion from the low point of the recession (1975) to the first three quarters of 1977, the current balance fell by no less than \$30 billion. The increase in oil import costs (\$18 billion) more than makes up the difference. The fourth quarter 1977 column (Table VII-11) reveals the stimulating speculative effect upon dollar capital exports in that quarter of the widespread official interventions to resist the decline of the dollar – and this against the trend of relative interest rates.

<sup>11</sup> There is little suggestion in this of a monetary-fiscal mix tending to weaken the United States capital balance and hence the exchange rate of the dollar. United States monetary growth rates did tend to expand slightly during 1977, but clearly as the result of a strong cyclical revival of bank credit demand – against the tide of gradually tightening monetary policy and rising absolute and relative interest rates.

1976 and early 1977, and began to recover. Because this change occurred during 1977, year to year figures are only slightly affected (from -1.7 in 1976 to -1.2 in 1977). Since this change in direction was still so slight, its reflection in the year to year change of GNP growth was easily offset by the negative impact of the slowdown in world recovery upon our exports<sup>12</sup>.

An unusual and significant special development took place during 1977 in the diamond industry. Briefly described this amounted to the exploitation of a world wide speculative boom in diamond demand which, due to a lag in raw diamond prices, sharply boosted the local industry's terms of trade<sup>13</sup>, to build up an extraordinary inventory of raw stones (the increase is estimated in the area of \$300 million). Virtually the entire large rise in Israel's overall terms of trade (about 8 percent, equivalent to a rise of about 1.6 percent of national income) consisted of the rise of reported diamond export over import prices. The resulting gain in real income accrued to the diamond firms, who in effect used it to finance the inventory investment described. (The lag of diamond import prices was overcome in early 1978 by a 40 percent surcharge imposed by the De Beer Syndicate.) In the main, the speculative stock investment of 1977 simply delayed, but cannot eliminate, a one time favorable impact of the temporary terms of trade improvement (which amounts to a capital gain to Israel) upon the trade balance. To some extent the stock building went still further, obscuring part of the longer-run improvement in the trade balance.

A striking change did occur in the exchange rate (both nominal and real) of the Israeli pound during 1977. Along with other changes, the reform sought to equalize the rates for capital transfers and for exports. This, however, meant eliminating premia on exports entirely, while removing only a fraction of import duties (the "Hetel"). The effect was to raise the effective exchange rate for imports, and thus the protection rate for import substitutes, relatively to that for exports. Under these conditions the profitability of industrial exports was likely to suffer if the new floating rate had settled below their previous effective rate (about IL 15/\$). To avoid this the floating rate was initially supported by some reserve accumulation by the Bank of Israel. Thus the rate was kept from falling

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<sup>12</sup> We should note that the effect of the sharp slowdown in world market growth is clearly reflected in Israel's goods exports. However, the conventional calculation of service exports (especially tourism) involves a positive bias in 1977: less tourist revenues were diverted to the black market (see discussion in chapter V). We shall presumably avoid future distortions of this type due to the near elimination of the basis for a black market through the liberalization of convertibility.

<sup>13</sup> Price change estimates in this industry are considered less reliable than in others. However a major lag of import prices did apparently occur.

TABLE VII-13

**CHANGES IN FOREIGN CURRENCY VALUE OF \$ AND IL FROM  
SMITHSONIAN PARITIES, 1977**

(percent)<sup>a</sup>

	Change in IL		Change in \$ (Renter index)
	Weighted by imports	Weighted by exports	
January	-56.4	-52.7	- 5.8
February	-56.8	-53.2	- 6.7
March	-58.1	-54.4	- 7.5
April	-58.9	-55.0	- 7.0
May	-59.0	-55.2	- 8.0
June	-59.8	-55.9	- 9.5
July	-61.4	-57.4	-10.5
August	-63.1	-59.0	- 9.6
September	-63.9	-59.7	-10.2
October	-66.0	-61.6	-13.2
November	-80.8	-75.5	-14.4
December	-82.7	-77.3	-17.7

<sup>a</sup> These series show the cumulative changes (since December 1977) in the weighted average of Foreign Currency obtainable per Israeli pound (weighted by Israeli trade) or per dollar (Renter index). The share of the dollar in the change of value of the Israeli pound from linkage to the dollar to linkage to a "basket" of currencies, and then to a floating exchange rate.

<sup>b</sup> Rates for ends-of-month: this is only one of several possible indexes for the average value of the dollar, and it is oriented towards its rate in relation to the principal currencies (such as the German mark and the Japanese yen). During 1977, the decline against the latter was greater than against a wider range of currencies. For example, in relation to the fifteen other currencies constituting the Special Drawing Rights) (weighted in their shares in world trade), the decline was about 7 percent: in relation to all other currencies (weighted in US trade), it was still less.

below IL 15. This was considered to be a temporary development related to realization of capital gains. Later changes, including an increase in the demand for foreign currency assets (permitted following the reduction of exchange restrictions), helped to maintain the rate with little further reserve accumulation. Future rates will be affected inter alia, by the recovery of internal growth, a reversal of the diamond stock building noted above<sup>14</sup>, and previous real devaluations (especially for imports in October 1977). The outcomes remain to be seen and should not be taken for granted.

It should be noted, in addition, that Israel has some way to go to adjust fully to the system of a convertible floating currency. At some points during the first months, but fortunately not over long periods, speculative flows tended to be destabilizing (i.e. a rise in exchange rates tending to raise foreign currency demand, and rates, further). Such a reaction is not surprising, reflecting as it does the experience and expectations of the system of pegged rates in which movements occurred in only one direction, if at all. It is noteworthy that such tendencies were extremely short-term, and did not develop dangerous cumulative force.

Despite the fact that the changes in the exchange rate were relatively large in December and January, they barely reflected the large wave of demand for foreign currency deposits newly permitted in Israeli banks ("Patam"). The Bank of Israel could, and did, effectively supply the bulk of this demand without lowering its foreign currency reserves, because of the requirement that the banks redeposit about 85 percent of Patam deposits as part of this reserve<sup>15</sup>. Without this Central Bank supply, rate fluctuations would have been considerably steeper.

The December-January surge of foreign currency (Patam) demand primarily responded to, and satisfied, the need for one-time portfolio diversification into foreign currency assets following the exchange liberalization for Israeli residents. This interpretation is indicated by the fact that the slowing of the rise in the exchange rate after January did not produce a significant reversal of this shift. The speculative element was apparently subsidiary, contributing to the suddenness and speed of the process<sup>16</sup>.

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<sup>14</sup> Both the one time terms of trade profit and a large increase in "diamond fund" foreign currency credit helped to finance the stock investment in 1977. The latter source reduces but does not eliminate impacts on the exchange market.

<sup>15</sup> Note that this supply of foreign currency involves (like "conventional" intervention reducing official reserves) a corresponding fluctuation (cut) in the domestic money base.

<sup>16</sup> Market expectations regarding a probable rise in the rate due to official intentions to safeguard export profitability also played a part, especially in timing.

It requires experience of changes in both direction and speed of exchange rate movements for the two-way risks of a floating rate to be fully appreciated and hence for speculation to adopt a stabilizing character. Experience is also needed to develop the demand for services designed to hedge such risks, (such as forward exchange markets). Thus the early stages of a float normally require more intervention if sharp fluctuations are to be avoided. This poses, to some extent, a dilemma in the conflicting need for two-way fluctuations and the desire to avoid the economic trauma of sharp fluctuations. The practical answer appears to be to dampen but not suppress fluctuation while the economy gradually adapts to the new system. Considering the complications posed by far reaching liberalization, in addition to the usual inexperience, the early response of the Israeli economy to a floating currency may be judged quite encouraging.