CHAPTER VII

BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

The deficit on current account[1] increased significantly over the last three years, from an annual $850 million in 1978–80 to $1.4 billion in 1981 and $2.2 billion in 1982 and 1983; these figures reflect a cumulative deterioration in all components of the balance-of-payments. In 1983, as in 1982, the private sector current-account deficit[2] grew rapidly, the net result of a moderate growth in exports, the prolonged and rapid growth of imports, and a slight decline in unilateral transfers. The public sector's current-account deficit, which contracted in 1982, turned into a surplus in 1983, owing to the fact that defense imports declined in both years and that part of the U.S. grant-in-aid for 1984 was received at the end of 1983.

Long-term capital imports by the private sector, previously an insignificant item, grew by $1 billion; about half of this increment was long-term borrowing by the private sector; the other half was purchases of securities on the Tel Aviv Stock Exchange; the latter reflects support of bank share prices; this is classified as foreign residents' investment in Israel and is thus not recorded as borrowing from abroad, although some of it might be more appropriately classified in this way.

The private sector's basic balance[3] of $1¼ billion was financed by the public sector's basic balance of similar magnitude. The volume of foreign currency purchased by the private sector from the Bank of Israel this year exceeded the amount required to finance its residual deficit, owing to considerable hoarding of cash balances. The public's massive foreign currency purchases reflected both expectations of devaluation and the belief that other financial assets had become vulnerable. Over the year as a whole, foreign currency balances diminished (see Table VII–7).

[1] The import surplus *less* unilateral transfers from abroad, which is equal to net borrowing from abroad.

[2] For detailed definitions, see Table VII–2 and the notes to it. As indicated there, imports attributed to the public sector include only direct imports (i.e. the indirect import component of public consumption is not included). Those components of the deficit which are confined to the public sector need separate discussion, mainly in the annual analysis, because of annual fluctuations in defense imports and their financing and in other grants to the public sector. In the long run, this distinction loses significance, and it is best to examine the total deficit in the light of total resources available to the economy (see Section 2 below).

[3] That is, the deficit on current account *less* net medium and long term capital inflow (see Table VII–2).

Table VII–1

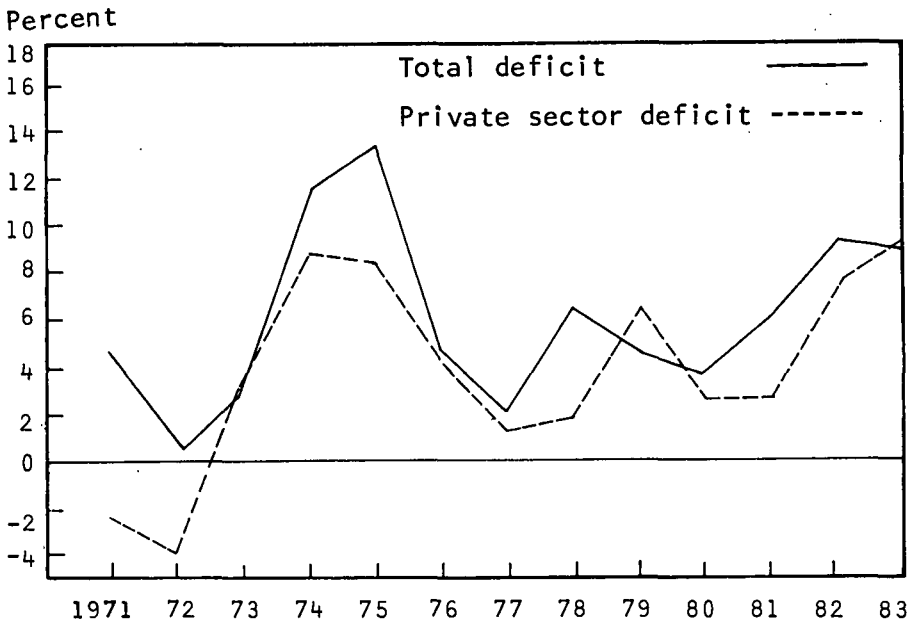
INDICATORS OF BALANCE OF PAYMENTS DEVELOPMENTS, 1977–83

	1977	1978	1979	1980	1981	1982	1983	Source
				$ billion, at current prices				Table
1. Current account deficit	0.3	0.9	0.9	0.8	1.4	2.2	2.2	VII–2
Thereof: Private sector	0.2	0.2	1.2	0.6	0.6	1.7	2.3	VII–2
2. Long- and medium-term capital import[a]	1.0	1.1	1.3	1.2	1.3	1.2	2.2	VII–2
3. Net external debt	8.8	9.5	10.7	11.6	13.4	15.5	17.7	VII–7
4. Import surplus								
Total	2.4	3.1	3.7	3.8	4.4	4.8	5.0	VII–3
Excl. direct defense imports	1.3	1.6	2.5	2.1	2.2	3.3	4.0	VII–3
Excl. direct defense imports and net capital services	0.9	1.1	1.9	1.2	1.3	2.2	2.8	VII–3
				Percent quantitative increase				
5. Exports, excl. capital services	11	6	4	6	5	–4	2	VII–3
Imports, excl. direct defense imports and capital services	6	5	7	–8	9	10	10	VII–3
				Indexes				
6. Representative sheqel exchange rate (annual average)								
Against U.S. dollar	1.05	1.75	2.54	5.13	11.43	24.27	56.24	
Against five-currency basket[b]	1.08	1.94	3.00	6.18	11.96	23.54	51.04	
7. World trade (quantity index)	100	106	112	114	115	113	115	VII–A17
8. Commodity terms of trade, excl. diamonds	100	104	99	93	92	96	97	VII–3
9. Import prices relative to prices of domestic uses[c]	100	110	105	108	104	98	92	National accounts
10. Export prices relative to prices of domestic uses[d]	100	108	104	105	98	95	94	National accounts

[a] Long- and medium-term loans and net foreign investment in Israel (including investment in securities).
[b] U.S., W. Germany, U.K., France, and Netherlands.
[c] Implicit national accounts price index at market prices. Imports and domestic uses do not include direct defense imports.
[d] Implicit national accounts price index, at factor cost.

Figure VII–1

DEFICIT ON CURRENT ACCOUNT AS PERCENT OF INCOME AVAILABLE TO THE ECONOMY, 1971–83[a]



[a] Income available to the economy is defined as GNP at factor cost (converted to dollars at the effective exchange rate) *plus* unilateral transfers from the rest of the world.

The last three year's cumulated increase in the current-account deficit is reflected in the large increase in the net foreign debt, which grew by 50 percent in 1981–83. Net capital services, imports of which at present account for one quarter of the total import surplus, also grew rapidly during this period. The growth of the external debt is all the more conspicuous at a time of slow economic growth—the debt/product ratio, which declined in 1979–80, has been rising again in the last three years (Figure VII–7). As a result, and because world interest rates have been rising since 1980, the burden of servicing the debt grew, especially in 1982 (Table VII–8), remaining at that level in 1983. In evaluating the external debt, it is important to look at its composition (as well as its temporal development), since this reflects the economy's ability to meet its obligations at any time. The composition of Israel's debt is favorable in three respects: the government is the biggest borrower; the lenders are foreign governments and world Jewry, whereas Israel has a surplus of assets over liabilities with foreign banks; and finally, short-term assets exceed short-term liabilities, although the short-term surplus contracted this year.

As mentioned, the 1983 balance-of-payments developments were part of a process that began in 1981, with domestic demand rising while product growth

slowed down,[4] so that civilian import surplus doubled within two years (from $2 billion in 1981 to $4 billion in 1983). In the last three years, the volume of exports rose by only 3 percent, in marked contrast to the 32 percent for civilian imports, with the terms of trade improving in each of the three years. (The improvement in the terms of the trade is connected mainly with the decline in oil prices, which had jumped in 1979 and 1980.)

The factors that explain why the balance of payments has been deteriorating since 1981 include some external factors related to world events and domestic developments related to fiscal, price, and exchange-rate policy. It was not until 1983 that the western economies began to emerge from the 1980–82 slump—the United States quite rapidly, and Europe, which is still the main market for Israeli exports, more slowly. The developing nations, which take a good slice of Israel's exports, also suffered from the depression, some of them undergoing financial crises in the last two years. The end of 1979 saw a sharp rise in world interest rates; they have declined since mid-1982, but the real 1983 level was still well above that of the 1970s. The dollar has strengthened steadily against European currencies since 1980, and this has not been offset by corresponding movements of prices in Europe; U.S./Europe relative prices have thus varied considerably in the period. As a result, although in 1980–82 the IS depreciated in real terms against the dollar, it appreciated relative to the basket of currencies of Israel's main trading partners, in particular relative to the European currencies.

Given this background of a troubled world economy, the expansionary fiscal policy of 1981 led to a significant real increase in disposable income and wages. The expansionary effects of public expenditure are manifest throughout 1981–83, although there were no considerable changes in its composition: 1981 saw a large increase in spending on subsidies and transfer payments, and the budget deficit doubled; in 1982, and especially in 1983, domestic defense spending grew, owing to the war in the Lebanon, so that disposable income and wages remained at the high 1981 level in spite of increased taxation.

Concurrently with the rise in domestic defense expenditures, a policy designed to slow down inflation was pursued. The kernel of this policy (which was embarked on in September 1982) was to hold the exchange rate and the prices of basic goods to a monthly rise of 5 percent, in an attempt to influence costs directly and to alter inflationary expectations. The measures adopted failed to reduce inflation below its average rate since 1979 (around 7 percent a month) and the relative prices of Israeli imports and exports dropped further the longer the policy was applied.[5] The combination of increased domestic demand and the decline in relative import and export prices shifted demand from domestic output to imports. This shift intensified from 1981 to 1982, and was accompanied by a reduction in domestic

[4] Domestic use of resources (*less* direct defense imports) rose by 20 percent over 1981–83; this contrasts with 6 percent for domestic product (estimated from the expenditure side) or 9 percent (estimated from indicators for the principal economic sectors).

[5] For a detailed description and the reasons for the failure to slow down inflation, see Chapter III.

Table VII–2

BALANCE OF PAYMENTS, 1979–83[a]

($ million, at current prices)

	1979	1980	1981	1982	1983
1. Net goods and services account	–3,657	–3,775	–4,355	–4,824	–5,039
Private sector	–2,256	–1,688	–1,735	–2,724	–3,268
Public sector[b]	–1,401	–2,087	–2,620	–2,100	–1,771
2. Net unilateral transfers	2,793	2,966	2,930	2,616	2,862
Private sector	1,091	1,136	1,147	1,063	948
Public sector	1,702	1,830	1,789	1,553	1,914
3. Net current account (1+2)	–864	–809	–1,425	–2,208	–2,177
Private sector	–1,165	–552	–588	–1,661	–2,320
Public sector	301	–257	–831	–547	143
4. Net medium- and long-term capital movements	1,268	1,325	1,287	1,228	2,170
Private sector[c]	117	–132	–45	–10	1,053
Public sector[d]	1,151	1,457	1,332	1,238	1,117
5. Net basic balance of payments (3+4)	404	516	–138	–980	–7
Private sector	–1,048	–684	–633	–1,671	–1,267
Public sector	1,452	1,200	501	691	1,260
6. Net short-term capital movements	231	–215	129	76	–595
Private nonfinancial sector	493	32	–54	4	–125
Public sector[e]	–262	–247	183	72	–470
7. Capital movements of the commercial banking system	740	123	737	1,629	222
8. Errors and omissions[f]	–956	5	–228	112	250
9. Increase (–) or decrease (+) in foreign exchange reserves of central monetary institutions[g]	–419	–429	–500	–837	130

NOTE: In capital movements an increase in liabilities is a positive magnitude while an increase in assets appears with a minus sign.

[a] Data for 1980–82 have been revised by the Central Bureau of Statistics.

[b] The public sector deficit on goods and services account is defined as follows: direct defense imports, government imports n.e.s., and net interest payments to rest of world, less port services surplus (excl. fuel) and communication services surplus.

[c] Equal to line 3 in Table VII–A11 plus line 3(b) in Table VII–A12.

[d] Includes allocations of IMF Special Drawing Rights.

[e] Consists mostly of defense import advances. These were first published by the Central Bureau of Statistics in 1981 and calculated back to 1975. They are not included in Israel's external debt or its foreign assets.

[f] Includes errors and omissions in the balance of payments of Judea-Samaria and the Gaza Area.

[g] Adjusted for changes in the value of foreign currencies against the dollar and the revaluation of foreign securities held by the Bank of Israel.

SOURCE: Based on Central Bureau of Statistics data.

saving. The latter was itself caused by the factors mentioned above as well as by the diminishing attractiveness of savings; in 1982 a tax was imposed on stock market transactions and by 1983 the public was concerned about further measures that would reduce yields.

Exchange-rate policy affected the composition of the public's portfolio as well as the size and composition for the demand for goods and services. So long as the real appreciation of the IS was expected to continue, the public shifted from foreign-exchange linked assets to local-currency denominated interest-bearing assets; the shift was accompanied by an inflow of foreign capital, particularly at the end of 1982. Subsequently, with real appreciation reaching significant proportions, the public realized that a policy change was due, and expectations of a corrective devaluation resulted; as these expectations intensified in the first half of 1983, the public increased its purchases of imported goods and the proportion of foreign assets in its portfolio, at the expense of IS-denominated assets. Thus, instead of the capital inflow and the increase in foreign reserves which occurred at the end of 1982, we have the reverse process in 1983; large purchases of foreign currency by the private sector.

Since 1981, and especially since September 1982, the relative price of exports, imports, and foreign financial assets fell.[6] In agriculture and industrial exports, the fall was largely offset by exchange-rate insurance and directed credit; however, services exports, some import substitutes, and capital movements suffered from real appreciation. Since the inflation rate failed to decline after several months of the 5 percent policy, and as the import surplus and the foreign debt grew, a gradual retreat began: devaluation substitutes were introduced for imports and the rate of devaluation was stepped up in the middle of the year. The devaluation substitutes, which are applicable mainly to merchandise, are reflected in the widening gap between the effective exchange rate of merchandise imports and the (official) exchange rate for imports of services and capital movements, a gap that directly accounts for the growing disequilibrium in the money market.

The growth of the foreign currency component (both Patam and cash) of the portfolio was accompanied by the sale of local-currency assets. By the beginning of 1983 the public had already begun to unload its bank shares, whose prices had risen steeply in the preceding years; however, these shares were taken up by institutions connected with the banks and partly financed by a large capital inflow. As expectations for devaluation reached new heights in October 1983 and the public made massive purchases of foreign currency, the sale of bank shares reached proportions which made it extremely difficult to continue supporting their prices. The Stock Exchange was closed for two weeks, during which there was a radical policy switch: the IS was devalued by 23 percent, prices of essentials were raised by

[6] For exports this means the price of exports relative to the price of domestic final uses at factor cost, and for imports, the price of imports relative to the price of domestic final uses at market price (Table VII-1). For foreign financial assets, the relative price is the exchange rate of the dollar relative to inflation-rate differentials between Israel and the United States.

50 percent, and an agreement was reached concerning the bank shares, although a considerable decline in their real value could not be prevented. In November, the purchase of foreign currency other than for travel abroad was prohibited.

The last quarter of 1983 was dominated by the stiff devaluation and the ensuing steep price increases. The 23 percent devaluation was primarily designed to calm the money market, since the effects of the 7 percent devaluation in August did not last. The attempt to reverse the real appreciation trend by a single large devaluation generated exceptional price increases in the commodity markets, while the real depreciation attained was quite small. Price increases continued throughout the period after October 1983. By the last quarter of 1983, economic trends were swinging round; in some areas (such as merchandise exports) the change was already discernible at mid-year. It stemmed from, among other things, a large decline in the value and liquidity of the public's wealth (because of the decline in the value of bank shares), and a steep drop in real wages due to sharp price increases. Exports continued to rise and imports to contract in the first quarter of 1984, during which domestic demand remained slack, while recovery in the world markets gathered momentum.

The last three years' deterioration of the balance of payments on current account has greatly increased the foreign debt, a process that cannot go on indefinitely, in spite of the favorable composition of the debt. Although in the second half of 1983 and the beginning of 1984 the import surplus and the current-account deficit declined, they are still high and the foreign debt continues to grow. The large size of the last few years' deficit stems from a long-run structural factor (the high level of public consumption combined with a large budget deficit) whose effects have in the last few years been compounded by a sharp decline in private saving. It must therefore be stressed that a necessary condition for slowing the growth of the foreign debt to a rate which the economy can cope with in the long run is for public consumption to contract and private saving to recover.

2. THE CURRENT ACCOUNT

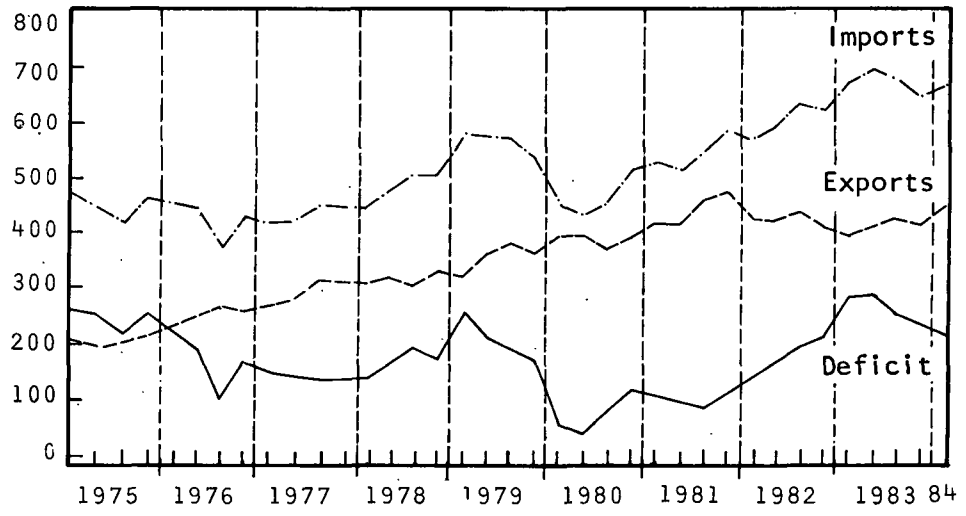
The government influences the size of the current account deficit both directly, by determining the volume and composition of public expenditure, and indirectly—through its policy in general, which affects private consumption, investment, and output. The current-account deficit is equal to the difference between that part of domestic final expenditures not financed by unilateral transfers and GNP. The closer the economy is to full employment, the more the current-account deficit is determined by the magnitude of domestic final expenditure (relative to GNP) and the less it is determined by their composition. Increased spending thus spills over into the balance-of-payments deficit.[7] Figure VII–3 shows private and public

[7] This is not true when there is unemployment: demand can then be stepped up without increasing

Figure VII–2

TRADE DEFICIT (EXCLUDING DIAMONDS AND FUEL), 1975–83

(Millions of 1972 $, seasonally adjusted quarterly data)



consumption (respectively net of unilateral transfers to the private and public sectors), investment, and the current balance-of-payments deficit, all as a percentage of GNP. As can be seen, the deficit/GNP ratio doubled from 1980 to 1982; the slight contraction in 1983 was a result of the heavy inflow of grants at the end of the year.

Public consumption other than that financed by foreign grants rose in 1980 and 1981 to reach 28 percent of GNP, the highest level since the Yom Kippur War and the subsequent military re-equipment; the ratio declined in the last two years, primarily because direct defense imports contracted by more than the increment in domestic defense consumption.

The ratio of private consumption (*less* foreign grants to the private sector)[8] to GNP grew moderately between 1974 and 1980, reaching 54 percent in 1980. In the last three years, the growth rate of consumption accelerated and the ratio reached 60 percent in 1983. This acceleration reflects the considerable expansion of private consumption (stemming chiefly from the decline in the relative prices of imports) and a moderate decline in foreign transfers to the private sector.

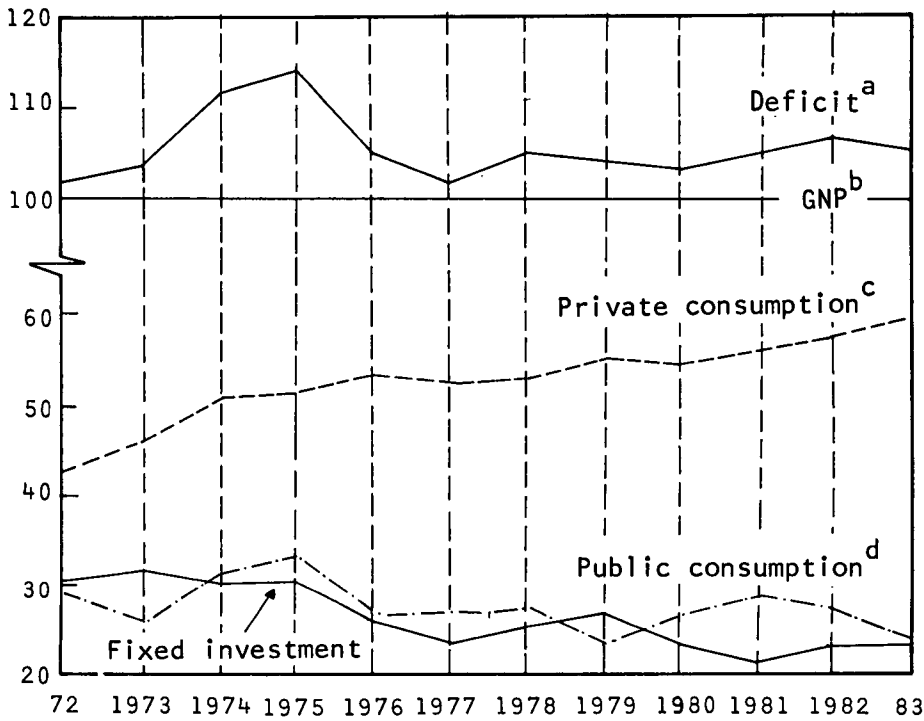
the deficit, by means of appropriate measures designed to translate incremental demand into incremental GNP.

[8] There is some correspondence between unilateral transfers to the government and public consumption; this is not true of private consumption; however, private and public consumption are here treated in the same way, since both differ from investment inasmuch as the latter creates future productive capacity.

Figure VII–3

NATIONAL EXPENDITURE AND THE DEFICIT ON CURRENT ACCOUNT, 1972–83

(Percent of GNP at official exchange rate)



[a] At official exchange rate.
[b] Net of unilateral transfers.
[c] Net of unilateral transfers to private sector.
[d] Net of unilateral transfers to public sector.

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

The high level of public consumption in the last decade and the rise in private consumption (both net of foreign transfers) were not fully reflected in the current deficit, since the investment/GNP ratio dropped from 30 percent in 1972–75 to 21 percent in 1981. In the last two years this trend was arrested and investment rose to 23 percent of GNP. If the decline in investment reduces the current-account deficit in the short run, in the long run it might have the opposite effect: product growth slows down, as it has in Israel in the last decade, and there is more spillover of expenditure into the current-account deficit.

Thus it becomes a matter of urgency to reduce that part of public consumption which is not financed by foreign grants (as well as to curb the excessively rapid growth of private consumption), in order to permit higher investment and faster product growth, subject to a reasonable current balance-of-payments deficit constraint. Furthermore, a substantial reduction in the ratio of public consumption

Table VII–3

GOODS AND SERVICES ACCOUNT, 1980–83[a]

	Current $ million				Percent annual increase							
					Price				Quantity			
	1980	1981	1982	1983	1980	1981	1982	1983	1980	1981	1982	1983
Imports												
a. Goods, excl. fuel and diamonds	4,316	4,964	5,190	5,665	14.3	–4.5	–6.9	–4.0	–20.3	20.4	12.3	13.7
b. Oil and other fuel	2,116	2,043	1,914	1,608	44.6	2.9	–12.9	–8.6	4.1	–6.2	7.6	–8.1
c. Diamonds	1,120	529	572	782	9.3	–10.3	–8.5	0.7	11.3	–47.3	18.1	37.8
d. Services, excl. capital services	2,133	2,473	2,669	2,897	14.9	–3.8	–2.3	–2.2	–3.0	20.6	10.5	11.0
e. From Judea-Samaria and Gaza Area	522	614	618	677	15.4	–4.9	–1.4	1.1	5.0	23.7	2.0	8.3
f. Total civilian imports, excl. capital services	10,208	10,624	10,963	11,629	18.1	–4.7	–6.5	–3.9	–8.1	9.2	10.3	10.3
g. Capital services	1,966	2,320	2,754	2,666								
h. Direct defense imports	1,693	2,190	1,552	1,028								
i. Total imports of goods and services	**13,866**	**15,134**	**15,269**	**15,323**								
Exports												
a. Goods, excl. diamonds	3,806	4,171	4,002	3,826	14.7	–3.3	–5.4	–3.6	8.9	13.3	1.4	–0.8
b. Diamonds	1,409	1,067	905	1,001	5.6	–6.5	–5.9	–2.8	9.0	–19.0	–9.9	13.8
c. Services, excl. capital services	3,117	3,266	3,103	3,226	15.6	1.3	1.9	2.5	1.3	3.4	–6.8	1.5
d. To Judea-Samaria and Gaza Area	706	789	777	822	15.6	–0.2	4.7	4.8	7.0	12.0	–6.0	1.0
e. Total exports, excl. capital services	9,039	9,294	8,786	8,875	14.0	–1.9	–1.8	–0.6	5.7	4.8	–3.7	1.6
f. Capital services	1,052	1,485	1,658	1,409								
g. Total exports of goods and services	**10,091**	**10,779**	**10,445**	**10,284**								
Trade deficit, excl. Judea-Samaria and Gaza Area												
a. Excl. fuel and diamonds	510	793	1,187	1,838	–9.4	–1.3	–2.1	3.4	–66.7	57.3	53.1	49.7
b. Current surplus on diamonds	289	538	333	218								
c. Total trade deficit	**2,337**	**2,298**	**2,769**	**3,228**	62.4	2.8	–26.0	–11.0	–48.5	–4.3	62.9	31.0
Civilian import surplus, excl. capital services	1,169	1,330	2,177	2,754								
Net capital imports	914	835	1,096	1,257								
Civilian import surplus	**2,083**	**2,165**	**3,272**	**4,011**								
Total import surplus	**3,775**	**4,355**	**4,824**	**5,039**								

[a] Based on c.i.f. valuation of commodity imports and f.o.b. valuation of commodity exports.

SOURCE: Based on Central Bureau of Statistics data.

to GNP is a precondition for halting the growth of the foreign debt (in other words, balancing the current account).

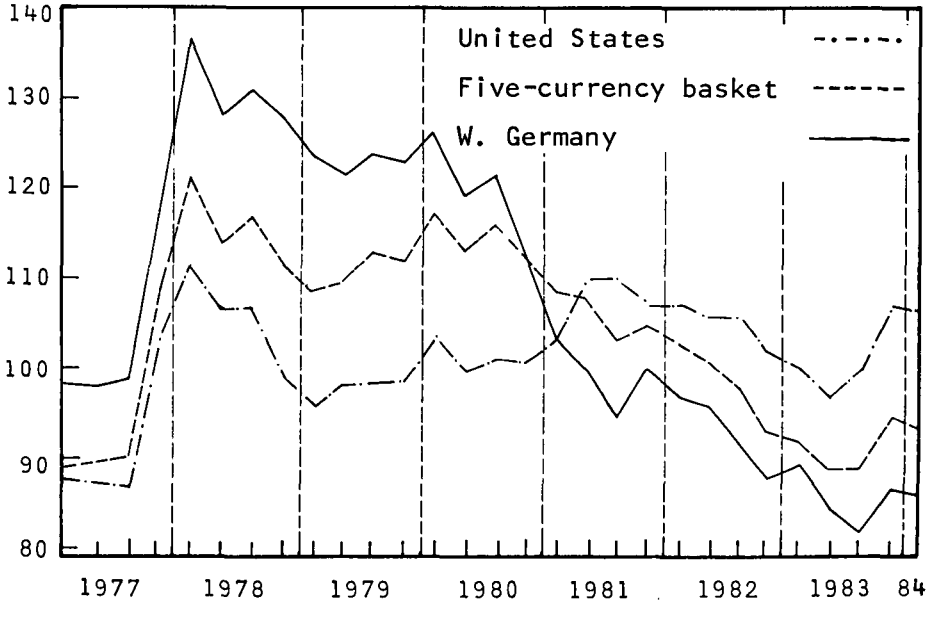
The government's indirect contribution to the development of the deficit is complex: the volume of public spending and its composition, tax policy, directed-credit policy, exchange-rate policy and international trade agreements—all affect the private sector's production and consumption activities, and hence also the deficit. In what follows, the focus is on the exchange-rate policy of the last three years.

In mid-1980, the dollar began to pick up vis-a-vis most other currencies (including those of the European countries, with which Israel trades extensively), a process which still continues. It was not accompanied by corresponding price changes in the various countries, so that world relative commodity prices changed markedly, posing severe difficulties for Israel (a small country with a relatively large volume of trade), difficulties that exchange-rate policy is incapable of solving.

Figure VII–4

RELATIVE PRICES OF INDUSTRIAL GOODS—WORLD/ISRAEL, 1977–83[a]

(Index, 1972 = 100, quarterly data)



[a] Wholesale prices of industrial output abroad in IS terms *divided by* the appropriate domestic price indexes.

[b] The five currencies are the US dollar, the Deutsche mark, the pound sterling, the French franc, and the Netherlands guilder.

SOURCE: IMF, *International Financial Statistics*; Central Bureau of Statistics; and Bank of Israel calculations.

Table VII–4

RELATIVE PRICES OF INDUSTRIAL GOODS: ISRAEL AND SELECTED TRADING PARTNERS, 1980–83[a]

(Indexes: 1980=100)

	U.S.A.	Europe	In terms of 5-currency basket	4 European currencies[b] against the dollar
1980	100	100	100	100
1981	106	87	93	82
1982	104	78	86	75
1983	100	70	80	70

[a] Trading partner/Israel. For details see Table VII–A8.

[b] Pound sterling, German mark, French franc, and Dutch guilder.

SOURCE: Bank of Israel.

It takes time to develop exports to new destinations in response to relative price changes; it takes much less time to shift to imports and this creates problems for the producers of import substitutes during the adjustment period. In 1981, the IS/$ rate rose rapidly and U.S./Israel relative commodity prices rose markedly as a result (see Table VII–4 and Figure VII–4). In spite of this, Europe/Israel relative commodity prices declined, as did the average for trade with U.S. and Europe combined (in terms of the 5-currency basket,[9] weighted by Israeli trade weights). The attempt to keep relative prices (in terms of the basket of currencies) stable by devaluation of the IS was abandoned at the end of 1981, because of concern over the danger of accelerating domestic inflation, and because it was expected that the dollar's uptrend would level off or even reverse itself.

From the end of 1982, the policy was to slow down devaluation, a policy pursued until the events of autumn 1983 described in the preceding section. Thus in the course of a three-year period, the relative price dropped by 20 percent (in terms of the basket of five currencies) and by more (in terms of the basket of four European currencies), whereas the U.S./Israel relative price returned to its 1980 level in 1983. In view of the difficulties confronting exchange-rate policy and because it was being used to combat inflation, the government turned to alternative measures. In 1981, *ad hoc* aid was extended to several exports which had been particularly hard hit; towards the end of 1981, exporters' exchange-rate insurance was introduced. This arrangement was designed as insurance against loss due to differential movement of the exchange rate and domestic prices during the production period, the premiums varying by destination in order to mitigate the effects of changes in world relative prices. Since its introduction, the arrangement has been extended to the majority of merchandise exports and some invisibles (hotel services, for example).

[9] The currency baskets referred to in this chapter are the 4-currency basket (pound sterling, German mark, French franc, and Dutch guilder), and the 5-currency basket which also includes the U.S. dollar.

The government also took steps in the field of import taxes. Following the 1981 cut in tax rates on heavily taxed imports and a further large decline in the prices of consumer goods (due to foreign price developments) the government began to introduce measures to reduce imports: in June 1982, import duties were raised more than taxes on domestic products and foreign travel tax was imposed; it was suspended after six months and reimposed (at a higher rate) in mid-1983. A deposit requirement embodying a large tax element was imposed on a list of goods whose main destination is consumption, as well as on goods with close locally produced substitutes, and purchase tax was raised. Administrative steps were taken and special taxes levied (under the provisions of the Prevention of Dumping Law) on imports posing a real threat to domestic products in order to prevent the closure of plants and unemployment. The net result of these measures and the exchange-rate policy of the period was a differential decline in the price of imports; smaller in products with domestic substitutes and greater in the others.

The resource misallocation that results from devaluation substitutes needs no stressing; what should not be forgotten is that their extension to a wider range of commodities moderated the contractionary effects of slow devaluation, especially in 1983, so that unemployment did not go up and there was some recovery of product growth. However, the government's slow devaluation policy, which was regarded as temporary, induced the marked spurt in consumer spending which is its chief contribution to the 1983 rise in the deficit. None the less, slow devaluation did stimulate investment.

When the 5-percent devaluation policy was dropped at the end of 1983, government exchange-rate insurance payments to exporters declined. No adjustment was made on the import side, where there is no such automatic mechanism.

The combined effect of world and domestic developments was a significant real appreciation of the IS. One indicator of this (see Table VII–1) is the marked decline in the price of imports and exports relative to the prices of domestic final uses (respectively 15 and 10 percent over 1980–83).

Exports

The volume of exports of goods and services (excluding capital services) both rose in 1983, by 1½ percent (in 1982 total exports declined by 4 percent). This is a departure from the rapid growth of the preceding decade, with its consistent rise in the export/GNP ratio. This year's modest growth in exports is the net result of strong growth in some industries and contraction in others. Agricultural exports went down and military exports dropped sharply. Industrial exports for civilian use, on the other hand, expanded and diamond exports rose—it seems that the prolonged recession in this industry had come to an end. The volume of tourist services exports grew, while exports of other services declined.

After a long period in which they were a growth leader, industrial exports ceased to expand. In 1983, they dropped by $150 million, while the volume remained

Table VII–5

GEOGRAPHICAL DESTINATION OF ISRAEL'S COMMODITY EXPORTS, 1980–83[a]

(Percentages; calculated from current-price dollar data)

					Percent annual increase	
	1980	1981	1982	1983	1982	1983
Europe[b]	52	45	42	45	–10	2
North America	13	17	18	21	–2	16
Other	35	38	40	34	2	–20
Total	**100**	**100**	**100**	**100**	**–4**	**–5**

[a] Excludes fuel and diamonds.

[b] Common Market and European Free Trade Association.

SOURCE: Central Bureau of Statistics.

unchanged (for the second year running, see Tables VII–A4 and VII–A5). Exports of military products and aircraft fell sharply, but other industrial exports grew by 7 percent. The trough in exports came at the beginning of 1983, when there were signs of recovery from the downswing that began in mid-1981, a recovery which continued into the beginning of 1984.

The sluggish development of industrial exports stems from a combination of factors at work in recent years, including world market developments. In 1983, recovery of demand from the slump in the export markets, which was at its deepest in 1982, was only partial and was concentrated in the United States. In Europe, recovery came later and was more modest, while some of the developing countries have not yet recovered from the financial crises which hit them in 1982. The dollar continued to rise vis-a-vis the European currencies and this has aggravated the difficulties of exporting to Europe as well as stiffening competition from European exporters in other export destinations. At home, domestic demand continued to expand rapidly; thus defense establishment purchases from industry grew steeply, in connection with the war in the Lebanon. Exchange-rate insurance on average prevented further deterioration of the profitability of industrial exports during the year, but it can only partly compensate for the diminished profitability of exports to Europe; exports to the United States have enjoyed improved profitability in recent years.

The growth-rate of industrial investment rose in 1982 and 1983, particularly in electrical and electronic products, chemicals, mining and quarrying, and rubber and plastics. The development of the exports generated by these investments differs from one industry to the next, since each faces different markets. It is not easy to make quantitative estimates of the contribution of the various factors to export developments, and they presumably operated to different degrees in different export industries.

Israel's principal export markets are in Europe, but their share has been falling

gradually for several years now, in favor of the United States and the developing countries. The shift to the United States accelerated as the dollar strengthened in 1981, was checked in 1982 by the sharp recession there, and resumed in 1983 (see Table VII–6). The 1983 rise in the proportion of exports going to Europe also reflects a 7 percent rise in industrial exports to Europe and a decline in exports to "other countries." The latter consists of a decline in civilian exports to developing countries and a steep decline in military exports.

Imports

There have been marked changes in the economic destination of imports in the last few years (see Table VII–A1). Most of the change occurred in direct imports (rather than in the final destination of intermediates). Direct defense imports declined, as did inputs to export production, owing to the reduced volume and changed composition of exports. In contrast, direct imports of capital goods and imports of capital services increased considerably, the latter reflecting interest payments. The proportion of imports going to private consumption remained high, with a large increase in the volume of consumer goods and tourist services accompanied by a steep decline in their dollar prices.

Merchandise imports fell in 1983, reflecting the sharp decline in oil and direct defense imports (see Table VII–A3). Other merchandise rose by $500 million, or by a real 14 percent (compared with 12 percent in 1982). About 60 percent of these imports were intermediates, which rose by 7 percent; of the rest, producer durables rose by 33 percent, and consumer goods, by 20 percent.

The decline in the relative price of imports and expectations of a large devaluation and higher import duties increased household demand for durables and for travel abroad, as well as firms' demand for imported producer durables, a demand that intensified as confidence in financial assets weakened.

The appreciation of the dollar had a significant effect on the distribution of imports by country of origin (see Table VII–6): imports from North America rose less than those from Europe and other countries, whether measured in current

Table VII–6

GEOGRAPHICAL ORIGIN OF ISRAEL'S IMPORTS, 1980–83[a]

(Percentages; calculated from current-price dollar data)

	1980	1981	1982	1983
Europe[b]	54	55	56	57
North America	32	31	29	28
Other	14	14	15	15
Total	**100**	**100**	**100**	**100**

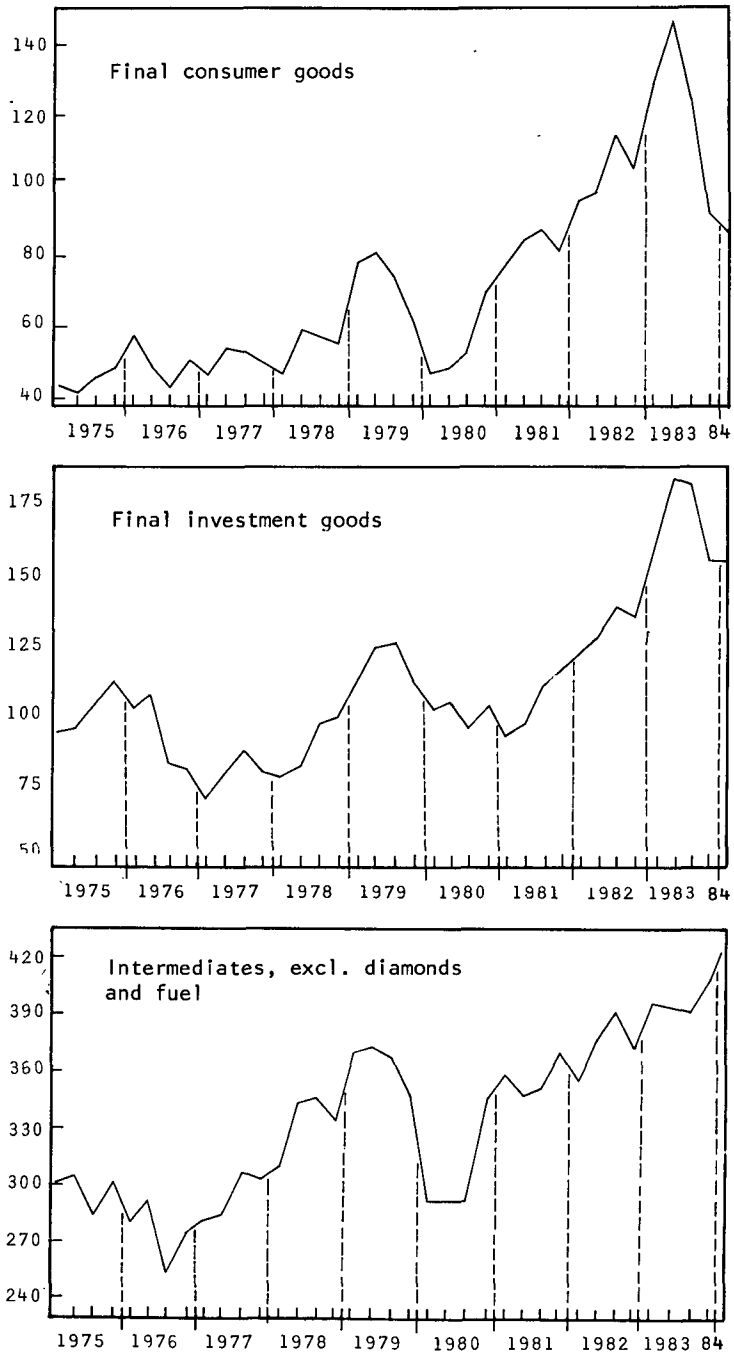
[a] Excludes direct defense imports, fuel, and diamonds.
[b] Common Market and European Free Trade Association.

SOURCE: Central Bureau of Statistics.

Figure VII–5

MERCHANDISE IMPORTS, 1975–83

(Millions of 1972 $, seasonally adjusted quarterly data)



dollars or in volume terms; however, the latter shows a much stronger shift to Europe.

Services

The services account has deteriorated steadily since 1979 (when exports and imports balanced). The large contribution of capital services to the total current-account deficit is explained as a built-in deficit, since Israel is a net borrower: most of the import surplus on services account stems from the gap between interest payments and receipts, the remainder stemming from the dividend account. The 1983 decline in interest rates affected the two sides of the interest account differently: receipts fell by $230 million or to the full extent of the decline in interest rates, but payments by only $100 million This is because the volume of current interest-bearing assets exceeds liabilities of this type, and also because the debt grew during the year.

The volume of tourism exports grew this year by 5 percent, the number of tourist days increasing by 9 percent; this compares with last year's 8 percent decline.

The number of Israeli tourists abroad grew significantly in 1983 (by 26 percent, as measured by the number returning within three months); imports of tourist services, which rose in both of the two preceding years, increased by 20 percent.

3. THE CAPITAL ACCOUNT[10]

Net capital imports came to $1.8 billion this year, consisting of net inflows of $2.2 billion medium and long term capital and $0.2 billion via the banking system, and a net outflow of $0.6 billion short-term capital.

In 1983 the composition of capital imports was exceptional, since for many years there has been virtually no net import of long-term capital by the nonfinancial private sector. This year, however, there was an inflow of $1 billion, about half of which is classified as foreign investment, so that it does not appear as an increment to the foreign debt (see Section 1).

Even though the basic balance was close to zero, with the public sector surplus financing the private sector deficit, the reserves of the central monetary institutions fell (by $130 million) because of the net outflow of short-term capital.[11]

As in previous years, most (79 percent) of the government's long-term borrowing was from the United States. These loans are extended for long periods (i.e. the principal is repaid on favorable conditions) and at fixed interest rates: Israel has not been exempt from the rise in long-term interest rates in the American

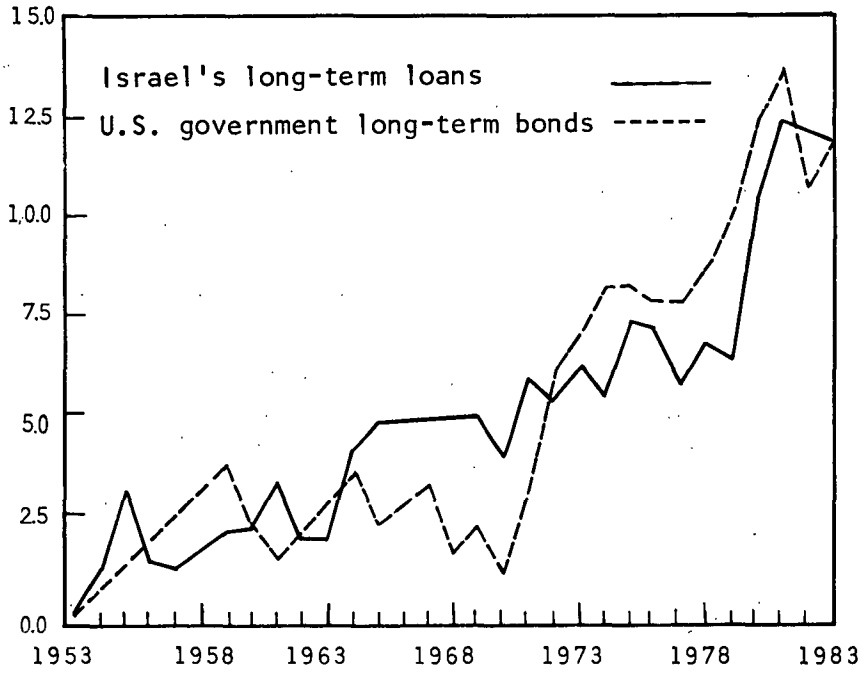
[10] The balance of payments has been revised back to 1980 by the Central Bureau of Statistics, with major revisions that affect private nonbank short-term capital flows. (The tables on the external debt and foreign currency assets have been revised back to 1974.)

[11] The change in reserves also includes exchange-rate differentials arising from changes in the rates of the various foreign currencies against the dollar.

Figure VII–6

INTEREST RATE ON FOREIGN LOANS AND U.S. GOVERNMENT BONDS, 1953–83

(Percent)



SOURCE: IMF, *International Financial Statistics*; Bank of Israel, *Israel's External Debt* (Controller of Foreign Exchange); and Bank of Israel calculations.

bond market, and the economy may eventually be paying a high real rate of interest on loans received in the 1980s. In the 1970s the rate was below that on long-term U.S. government bonds (i.e. it was subsidized), but at present the reverse is true. (However, it seems that the share of grants in total aid will increase in the future.)

4. THE EXTERNAL DEBT

In 1983, as in previous years, foreign loans financed part of the economy's current activities. The net[12] debt rose by 14.5 percent in 1983 to reach $17.7 billion at the end of the year. This is the third year that the net debt has grown by roughly 15 percent. The discussion that follows focuses on three aspects of the debt—its structure, its development during the year surveyed, and the debt burden.

[12] There are various ways of defining the foreign debt (see Table VII–7). The net debt ($17.7 billion at the end of 1983) is the relevant aggregate for economic analysis, since the change in it is identically

Table VII–7

FOREIGN CURRENCY ASSETS AND LIABILITIES, 1979–83

($ million, at current prices)

End of year	1979	1980	1981	1982	1983
1. Net liabilities (2–3–4)	10,708	11,640	13,370	15,475	17,714
2. Foreign currency liabilities	14,856	16,237	18,231	20,916	22,566
Government	9,769	10,962	12,252	13,378	14,548
Private nonfinancial sector	2,376	2,487	2,524	2,723	3,015
Commercial banks	2,711	2,788	3,455	4,815	5,003
3. Foreign reserves of central institutions[a]	3,234	3,526	3,814	4,317	3,780
4. Exporters' credit to foreigners	914	1,071	1,047	1,124	1,072
5. Current foreign liabilities	2,552	2,886	3,442	4,014	4,395
Net short-term liabilities of banks	971	903	1,490	2,094	2,199
Short-term liabilities of private nonfinancial sector	624	864	899	1,010	1,096
Long- and medium-term debt repayment due in following year[b]	957	1,119	1,053	910	1,100
6. Net current foreign liabilities (5–3–4)	–1,597	–1,711	–1,419	–1,427	–457
7. Net current liabilities/total liabilities (%) [(6/1)×100]	–15	–15	–11	–9	–3

[a] The actual change in the economy's foreign reserves. The figures here differ from those in Table VII–2 owing to the adjustment for foreign currency valuation changes in the latter table.

[b] The estimate for 1983 is from Table 8 in the National Budget (January 1984).

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

Structure of the Debt

In what follows, the structure of the debt is examined on the usual assumption that the economy's ability to continue borrowing abroad increases as the government's share and the term of the debt increase, and as the share of the debt to the world banking system declines.

Israel's foreign debt scores well on each of these criteria, and this presumably explains how Israel has managed to increase its net debt by $4.4 billion in the last two years—at a time when banks abroad have been trying to reduce their claims against high debt countries. It is customary to classify the debt by term. The current debt is defined as the sum of short-term debt and medium and long term loans to be

equal to the current-account deficit (net borrowing from abroad) *less* net foreign investment and exchange-rate differentials on foreign currency assets and liabilities. According to the data of the Controller of Foreign Exchange (Bank of Israel), the foreign debt includes the direct gross debt of the government and the private nonfinancial sector and the net obligations of the banking system ($22.6 million in 1983). The Central Bureau of Statistics defines the gross debt as total foreign currency liabilities and the net debt as gross debt *less* total foreign currency assets.

repaid in the near future. The net current debt is defined as the current debt *less* foreign currency assets (foreign currency reserves of central institutions and exporters' credit to abroad).[13] What is significant is that foreign currency assets exceed foreign currency liabilities, i.e. there is a net asset. It follows that part of the longer-term debt is invested in liquid assets abroad. It is for this reason that Israel has not run into liquidity problems in the years during which the debt has been accumulating (including 1983); however, the net current assets dropped by over $1 billion in 1983.[14]

Table VII–8

FOREIGN LIABILITIES BY CREDITOR, 1980–83

($ billion)

End of year	1980	1981	1982	1983
Total net liabilities	**11.6**	**13.4**	**15.5**	**17.7**
1. Foreign governments and international institutions	8.0	8.6	9.4	10.2
2. Independence and Development Loans (Israel Bonds)	2.6	2.9	3.1	3.3
3. Nonresidents' deposits	4.2	4.9	6.3	6.6
4. Other net liabilities to nonresidents[a]	–1.0	–0.8	–0.8	–0.5
5. Liabilities to banks abroad	6.2	7.1	8.2	7.9
6. Claims on banks abroad	8.2	9.4	10.8	9.8
7. Net liabilities to banks abroad (5–6)[b]	–2.1	–2.3	–2.6	–1.8

[a] Includes credit granted by Israeli banks to nonresidents and estimated customer credit by Israeli exporters.

[b] Includes credit granted directly to the government and the private nonfinancial sector by banks abroad (including overseas offices of Israeli banks), interbank deposits, and reserves of central monetary institutions.

SOURCE: Bank of Israel calculations.

The distribution of the net debt by borrower shows that the share of the public sector in the debt grew somewhat to reach 60 percent or more in 1983. If the banking system's debt to foreigners is classified by final destination, the public sector's share in 1982–83 comes to 70 percent.[15]

The distribution of the debt by lender illustrates the principal difference between Israel's debt and that of countries which have found it difficult to get loans and repay them in recent years. The principal sources of Israel's foreign debt are foreign governments (primarily in the United States) and world Jewry, and they

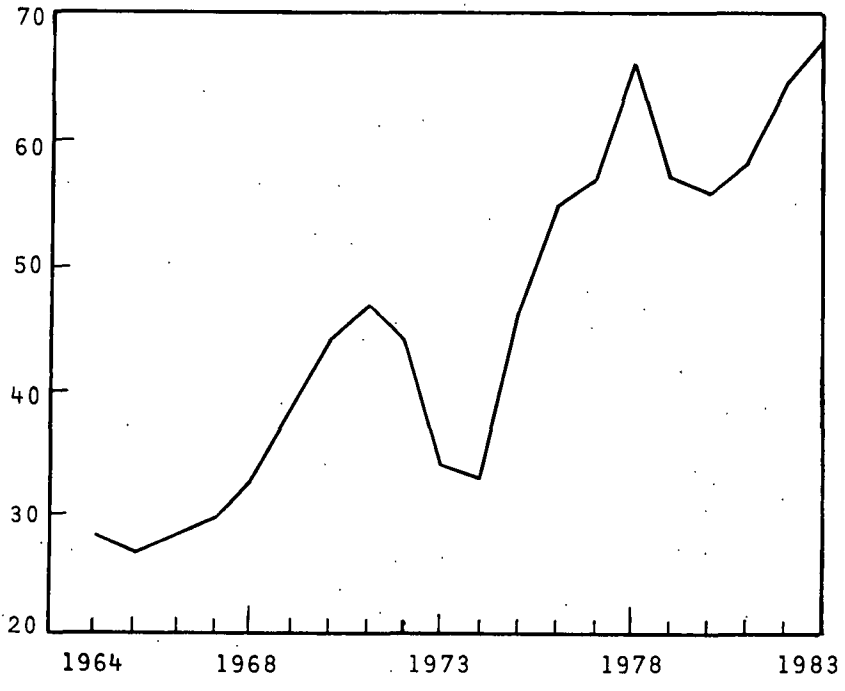
[13] Total assets are subtracted from the current debt since the reserves and exporters' credit may be realized in the short run.

[14] According to the balance-of-payments data (see Table VII–2) the public sector created short-term assets of close to $500 million in 1983, an amount not included in the asset statistics. Net current assets thus come to 5.2 percent of the net debt.

[15] Governments are considered safer borrowers than the private sector, and risk premiums are therefore generally lower for governments than for private borrowers.

Figure VII–7

NET FOREIGN DEBT AS PERCENT OF GNP, 1964–83[a]



[a] GNP converted to dollars at official exchange rate.

SOURCE: Central Bureau of Statistics.

have enabled the Israeli banking system and the public sector to be a net creditor of the world banking system to the tune of $2 billion.[16]

Although, as we have seen, the structure of Israel's debt in general facilitates borrowing abroad, two of its favorable features have in the last few years deteriorated—the weight of current assets in net debt fell from 15 percent in 1979 to 3 percent in 1983 (or to 5.2 percent—see note 14 above). In addition, net assets held with banks abroad fell from 16 percent of the net debt in recent years to 10 percent in 1983.

The Long-Term Debt

Although the preceding analysis has shown that Israel has not so far found it difficult to carry its foreign debt, and has even increased it, the question remains whether the developments of recent years were desirable. Looking back, it can be

[16] According to international definitions, the deposits of Israeli holders of nonresident deposits should not be included in the foreign debt. However, according to the definition used in Israel, these deposits (of close to $1 billion) are included, so that the foreign debt is overstated by this amount.

seen that in its early years, when the industrial base was being laid down and the financial system was not yet developed, it was profitable for the economy to accumulate a foreign debt, and indeed, in such circumstances it is natural for the debt to grow faster than output, so as to eventually reach the desired long-term level.[17] In the short run, a rapidly growing debt is also justifiable on the grounds that the domestic yield on investment exceeds the foreign yield. Even so, it is impossible for the debt to go on growing faster than output without laying up difficulties for the future. Figure VII–7 shows that the debt has now grown faster than product for three consecutive years.

Table VII–9

INDICATORS OF THE EXTERNAL DEBT BURDEN, 1978–83

	1978	1979	1980	1981	1982	1983
				$ million		
1. Interest payments on the gross external debt	934	1,232	1,797	2,205	2,596	2,499
2. Interest receipts from foreign currency assets	376	632	843	1,450	1,617	1,386
3. Interest payments on the net external debt	557	600	954	755	979	1,114
4. Other capital services						
a. Debit	60	146	169	115	138	164
b. Credit	118	175	210	34	39	22
5. Principal repayments o/a medium- and long-term debt	866	839	958	1,161	1,081	933
6. Total net debt service	**1,365**	**1,410**	**1,872**	**1,997**	**2,159**	**2,189**
				Percent		
7. Interest/net external debt[a]	6.3	6.1	8.5	6.0	6.8	6.7
8. Interest disposable income[b]	3.6	3.0	4.2	3.1	3.9	4.0
9. Net interest/exports[c]	9	8	11	8	12	13
10. Net debt service/exports	22	20	21	22	26	26
11. Net debt service/(exports + transfers)	18	15	17	18	20	20
12. Net debt service/GNP[d]	10	8	9	9	11	9

[a] Line 3 divided by the average net external debt.
[b] Disposable income equals GNP at the official exchange rate plus unilateral transfers.
[c] Exports f.o.b., excluding capital services.
[d] GNP in dollar terms, valued at the official exchange rate.

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

[17] It is sometimes argued that allowing the debt to grow at a rate not exceeding the growth of output is also a legitimate policy.

The Debt Burden

There are many indicators of the foreign debt burden, several of which are presented in Table VII–9. In the long run, the appropriate measure of the debt burden is the real interest rate paid abroad out of current income.[18] To calculate this indicator, the interest paid on the debt should be deflated by the expected rate of inflation abroad. Prices rose more slowly in the 1980s than in the 1970s in Israel's creditor countries, and the prices of Israel's imports and exports have also dropped in the last three years; this indicates reduced inflationary expectations, which, in combination with the increase in nominal interest rates in the last few years, suggests that the real interest rate at which Israel borrows is rising;[19] thus net nominal interest payments to the rest of the world rose from 1 percent of current income in the 1960s and early 1970s to 4 percent in the 1980s. According to other indicators (lines 10, 11, and 12 of Table VII–23), the debt burden rose in 1982 and remained at the same level in 1983.

The Bank of Israel's foreign reserves fell by $290 million in January–November 1983. However, at the end of the year they levelled off at $3,694 million, $142 million less than at the end of 1982.

[18] Current income is here defined as the sum of GNP in dollars (at the official exchange rate), and net unilateral transfers from abroad.

[19] The data on average nominal interest are poor and expected foreign prices unobservable. No attempt is here made to calculate the real rate of interest.