

## CHAPTER III

### THE BALANCE OF PAYMENTS – A GENERAL SURVEY

There was a remarkable improvement in a number of central balance of payments areas in 1976. Most notable are a considerable reduction of the deficit in the current account, a rapid increase in exports, especially in industrial exports, and an improvement in deficit financing. The latter was expressed by a remarkable increase in the weight of unilateral transactions and a decrease in that of loans, but mainly by a halting of the growing dependence on short-term sources for current deficit financing.

These developments brought relief to the short-term problems of the balance of payments, and removed the danger of a financing crisis. They also reflect the creation of conditions which promise continuation of the improvement by means of economic restraint. These conditions are a vital component in any strategy for solving the balance of payments problem.

Unfortunately these developments were achieved at a great price – a third year of standstill in economic growth. Despite the positive aspects of these developments, in as far as the balance of payments is concerned, they are mostly related to the immediate influence of restraint and the formation of a basis for further improvement. They have less effect on the core of the problem: the need to bring about a structural change that will get the economy out of its present standstill and return it to a course of growth, while at the same time continuing to reduce the deficit. Where relative prices and export profitability are concerned, there is still a wide gap between objectives and achievements. Some indicators show that recent changes are in the right direction. However, they may represent only a partial correction of the decrease in export profitability since 1972.

Finally, considering the change in allocation of resources in the economy, the progress towards desired objectives which was achieved in 1976 is not unequivocal. Recently, the share of consumption in the increment of resources has actually increased in comparison to 1972. There was in fact a change in this trend during 1976, expressed by the increase in the share of export, but this increase reflects not only rapid growth in exports, but also a considerable drop in the weight of domestic investment.

#### 1. THE BALANCE OF PAYMENTS PROBLEM

Developments in the balance of payments situation, and in particular the remarkable decrease of the current account deficit, are only one part of a complex picture. In order to evaluate their real significance, it is necessary to comprehend the relative weight of influences related to various levels of the problem: external factors, both incidental and

TABLE  
CURRENT  
(\$)

	Imports				Total incl. defense imports	Goods
	Goods	Services	Goods & services	Defense imports		
A. At current prices						
1971	1,758	767	2,525	555	3,080	900
1972	1,900	871	2,771	490	3,261	1,082
1973	2,896	1,176	4,072	1,253	5,325	1,366
1973 <sup>a</sup>	2,930	1,153	4,083	471	4,554	1,422
1974	4,073	1,605	5,678	1,224	6,902	1,706
1975	4,004	1,828	5,832	1,846	7,678	1,811
1976	3,974	1,963	5,937	1,603	7,540	2,281
B. At 1972 prices						
1971	1,871	798	2,669	584	3,253	966
1972	1,900	871	2,771	490	3,261	1,082
1973	2,264	1,023	3,287	1,129	4,416	1,114
1973 <sup>a</sup>	2,405	1,042	3,447	437	3,884	1,174
1974	2,324	1,171	3,496	978	4,474	1,175
1975	2,188	1,247	3,735	1,346	3,781	1,191
1976	2,225	1,255	3,529	1,129	4,658	1,472
C. Index of quanti- tative growth (1972=100)						
1971	98	92	96	119	100	89
1972	100	100	100	100	100	100
1973	119	118	119	230	176	103
1973 <sup>a</sup>	127	120	124	89	119	109
1974	122	135	126	200	138	109
1975	115	143	123	275	144	110
1976	117	144	125	230	140	136
D. Prices indexes (1972=100 )						
1971	90	96	95	95	95	93
1972	100	100	100	100	100	100
1973	128	115	124	111	121	123
1974	175	137	163	125	154	145
1975	183	147	171	137	164	152
1976	179	156	172	142	165	155

<sup>a</sup> First three quarters at annual rates.

III-1  
ACCOUNT, 1971-1976  
(million)

Exports			Deficit				
Services	Goods & services	Trade balance	Services	Total	Total incl. defense imports	C/a with admin. areas	Total current deficit
914	1,814	-858	147	-711	-1,266	40	-1,226
1,047	2,129	-818	176	-642	-1,132	31	-1,101
1,288	2,654	-1,530	112	-1,418	-2,671	29	-2,642
1,310	2,732	-1,508	157	-1,351	-1,822	28	-1,794
1,748	3,454	-2,367	143	-2,224	-3,448	61	-3,387
1,704	3,525	-2,193	-124	-2,317	-4,183	115	-4,050
1,844	4,125	-1,693	-119	-1,812	-3,415	145	-3,268
395	1,901	-905	137	-760	-1,352		
1,047	2,129	-818	176	-642	-1,132		
1,141	2,255	-1,152	118	-1,032	-2,160		
1,211	2,385	-1,231	169	-1,062	-1,499		
1,233	2,408	-1,149	61	-1,088	-2,066		
1,175	2,366	-997	-72	-1,069	-2,415		
1,190	2,667	-753	-65	-818	-1,947		
89	89	111	78	120	119		
100	100	100	100	100	100		
109	106	141	67	161	191		
116	112	150	81	169	135		
118	113	140	35	169	183		
112	111	122		167	213		
114	125	92		127	171		
98	95						
100	100						
113	118						
142	143						
145	149						
155	154						

short-range; the standstill in economic growth as a result of restraint policy (a necessary condition for carrying out structural changes but by no means a substitute for such changes); and structural changes concerning relative prices and the allocation of resources in the economy.

The aim of such an analysis is to show these developments in a wide perspective, in order to demonstrate the progress made in achieving the structural changes necessary for an effective solution of the problem.

In 1976 the deficit in the current account was reduced by nearly \$800 million. Part of this reduction resulted from a decrease of \$250 million in defense imports. In the current account excluding defense imports and trade with the administered areas, the deficit dropped by more than 20 percent, or \$500 million, totaling \$1.8 billion. The immediate significance of this drop is that the dangerous dependence on short-term sources has ceased growing. This dependence had characterized the previous two years, when need for short-term sources totaled \$ 2 billion. In 1976 long-term capital imports were able to finance the whole current deficit, and the growth of the above-mentioned dependence stopped, but the fact of dependence itself remained at the same high level it had reached at the end of 1975 (see Table III-3).

To a great extent the reduction of the deficit is the result of both short-term and incidental factors, and the effects of the restraint of economic activity. Nevertheless, in the last two years there are also indications of an improvement in the relative price of exports in certain fields.

There were significant changes in stocks of imported inputs. These changes explain nearly \$300 million of the decrease in the deficit. The transition from stockpiling to stock-liquidation was due partly to the adaptation to a low level of economic activity, and partly to considerations of relative profitability, reflecting the increase of domestic interest rates as well as changing expectations concerning prices and exchange rates.

The 10 percent cumulative decrease over the past two years in imported investment goods mainly reflects the influence of the restraint policy. It accounts for a decrease of \$ 50 million in imports but is not an expression of long-range trends. On the other hand, in 1976 stockpiling of raw diamonds accounted for an increase of \$ 100 million in imports.

One external factor also had a constraining effect: a decrease of world interest rates.<sup>1</sup> This is reflected by the fact that total foreign liabilities of the economy increased in the last two years by more than \$4 billion while payments of interest rose by only \$ 100 million.<sup>2</sup> A recovery of world interest rates to their long-term average level would mean a considerable increase of interest payments.

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<sup>1</sup> One indicator of this is the interest rates for one-year Eurodollar loans, which fell from 10.7 percent in 1974 to 6.7 percent in 1976.

<sup>2</sup> The comparison is not completely accurate, since the interest applies to the average debt, but this does not substantially change the picture presented here.

Another external factor explaining a decrease of about \$100 million in the current deficit between 1975 and 1976 is a slight improving in the terms of trade.

A deficit drop of \$300 million to \$350 million can be explained by a combination of all of these developments, in which incidental factors or the short-range effects of adaptation to economic policy had a determinant weight.

The restraint policy manifests itself mainly in the very fact that halting of growth creates a drop in imports and the creation of conditions for carrying out structural changes.

The sharp turnabout in export trends in 1976 is partly the result of the restraint policy. But it seems that the main cause is the less significant part of the policy effects in terms of long-range developments — those effects which reflect the inhibition of domestic activity, which is a short-range factor — and not the structural influence which the restraint was intended to make possible.

In 1976 exports increased by 13 percent in real terms, after an average increase of 4 percent in each of the previous three years. Exports of products increased by 22 percent, while industrial exports (excluding diamonds, minerals, and fuel) increased by 28 percent, after an average increase of 5 percent in the previous three years. Recovery of world demand played an important part in this rise. The increase of export profitability was less unequivocal. A comparison of product price in exports (and in tradeable goods in general) with (nontradeable) product price in the domestic market shows an improvement in the relative price of exports compared to 1975. But this improvement only partially compensates for the worsening which took place in the years 1973–74. From this aspect the situation is still significantly worse than it was in 1972, the year before the balance of payments crisis, while the developments that have occurred since then require a significant improvement relative to this starting point.

An analysis of industrial exports shows a lack of significant change in profitability when the comparison is made between the change of export prices and the cost level.<sup>1</sup> In comparison to the domestic market there was in fact an improvement, but it reflects the restraint of the domestic market, together with cost inflation, resulting in a strong pressure on profits. This situation does not reflect a permanent change in relative prices, but is related to the continuity of restraint policy and lack of growth.

World demand recovery stands out against these tendencies, as a factor for increasing exports. It should be remembered that a high rate of growth was achieved after three years of very slow increase, averaging 5 percent.<sup>3</sup> The cumulative rise of exports is still slow, compared both to the objectives in this area and the increase in production capacity of the economy. This is happening while unutilized production capacity is accumulating at a growing rate as a result of the restraint policy.

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<sup>3</sup> In industrial exports excluding diamonds, minerals and fuel.

TABLE  
CURRENT DEFICIT AND THE  
(\$ million,

	Current deficit	Long-term capital			Total	Surplus (+) or deficit (-) of long-term capital over the deficit	IMF credit
		Uni-lateral transfers	Long-term loans	Foreign investment			
1969	-869	459	168	18	645	-224	22
1970	-1,234	649	559	22	1,230	-4	—
1971	-1,228	766	642	75	1,483	-255	10
1972	-1,101	1,052	580	143	1,775	+674	-39
1973	-2,642	2,173	816	185	3,174	+532	—
1974	-3,387	1,737	539	94	2,370	-1,017	39
1975	-4,050	1,771	1,474	67	3,313	-737	215
1976	-3,268	2,239	1,011	44	3,294	+26	89
1975 I	-1,017	524	295	28	847	-170	94
II	-925	441	374	9	824	-101	16
III	-1,121	425	337	22	784	-337	—
IV	-987	381	468	9	848	-129	105
1976 I	-725	512	198	8	718	-7	—
II	-899	494	189	8	691	-210	—
III	-769	669	130	16	865	+95	75
IV	-875	563	444	12	1,019	+145	14

SOURCE: Central Bureau of Statistics.

### III-2

#### CAPITAL ACCOUNT, 1969-1976

(at current prices)

Short-term capital						Other items, esp. short-term foreign assets	Errors & omissions
Credit to non- financial sectors		Liquid foreign obligations of Israeli banks	Total short- term credit	Foreign currency reserves	Short- term capital		
Private sector	Government sector						
	-25	-38	-63	321	+258	-22	-64
	23	19	42	-19	+23	1	-49
	9	49	58	-245	-187	-125	47
	-36	-93	-129	-534	-663	-23	47
-6	+23	212	229	-526	-315	-266	28
+36	+46	464	546	+778	+1,323	-69	-272
+230	-70	528	688	-68	+620	-77	-18
+149	+78	95	322	-116	+206	-231	-92
+83	+14	297	394	-254	+140	-227	162
+37	-111	-62	-136	-8	-144	+158	74
+45	+11	2	58	+180	+238	+95	5
+65	+16	291	372	+13	+385	-104	-259
-24	+25	-120	-119	+59	-60	+86	-20
+139	+16	34	189	-64	+125	-71	154
-15	+53	42	80	-72	+8	-101	-79
+49	-16	140	173	-39	+134	-109	-147

**TABLE III-3**  
**CHANGES IN RESOURCE ALLOCATION IN THE ECONOMY, 1972-1976**  
 (percent)

	Rate of real growth		Weight in uses	Weight in increase of uses	Weight in increase of GNP <sup>a</sup>
	1972	1976	1972	1973-76	
<b>Uses</b>					
Private consumption	100	122.8	39.2	45.7	
Public consumption (excl. direct defense imports)	100	132.3	15.4	25.4	73.2
Total consumption	100	125.3	54.6	71.1	
Investment (excl. ships and aircraft)	100	96.8	21.8	-3.6	
Exports	100	126.8	23.6	32.4	26.8
Total uses	100	119.6	100	100	100
<b>Sources</b>					
GNP	100	116.0			
Imports (excl. defense imports)	100	127.6			

<sup>a</sup> Assuming a 40 percent import component in exports.

<sup>b</sup> This calculation ignores the effect of price differentials of different uses.



Most of the increase in exports was due to the growth of defense exports,<sup>4</sup> which represent a narrow segment of industry. Since they are subject to special factors, we must ask to what extent their vigorous growth is the result of these special factors and to what extent the result of the overall economic conditions.

An analysis of export tendencies and changes in relative prices shows the central function of economic restraint as a means of influencing the balance of payments. However, restraint can only function as a limited instrument of balance of payments policy, and achievements gained through it involve a heavy economic price. Restraint is a necessary component in dealing with this problem. Its function is to allow the necessary structural changes to take place, but it cannot be a substitute for them.

Two main structural changes are needed: raising the price of foreign currency in relation to domestic prices and wages — a change which will allow the expansion of exports (and import substitutes), and a change in the allocation of resources in the economy by decreasing domestic uses in relation to production. This will release resources for export needs. We are still far from achieving that change in relative prices required by balance of payments objectives. Some indicators show that recent changes are in the right direction, but apparently they can only correct in part the previous negative developments. Nevertheless, according to these indicators the correction in the last two years has been significant. The necessity still exists to bring the economy to above the level it attained before the severe crisis in the balance of payments occurred.

Some of the changes in the relative prices resulted from a combination of special factors. One of these was cost inflation in a restrained economy, expressed by pressure on profits. For this change to remain effective, the restraint must also continue. Logically, such conditions are a necessary component of policy in a transitional period. But they are not part of the long-range solution of the balance of payments problem, whose basic feature is the return to a course of rapid growth without balance of payments difficulties.

Nor has there been unequivocal progress towards the desired objective in as far as the reallocation of economic resources is concerned. In recent years, which were mainly years of restraint, a reverse change in resource allocation took place: instead of falling, the share of consumption in the resource increment rose appreciably (see Table III-3). A partial change of this trend did in fact take place in 1976, shown by a growth of export's share in resource increase. However, this increase — in a restraint economy — was actually made possible by a considerable drop in the weight of domestic investments.<sup>5</sup>

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<sup>4</sup> The average annual increase between 1973 and 1976, deducting defense exports, was 4–5 percent.

<sup>5</sup> Hypothetical calculations based on the given data show that an increase of 10 percent in product with no increase of the deficit will allow, after allocation of the needed resources for an increase in exports and a recovery of investments, an increase of 3–4 percent in consumption (1–2 percent per capita). Every calculation of this kind emphasizes the general outlines of the problem and the severity of its constraints.

TABLE III-4  
**INDICATORS OF EXPORT PROFITABILITY AND RELATIVE PROFITABILITY**  
**COMPARED TO DOMESTIC MARKET, 1973 TO 1976**  
 (1972 = 100)

	Industrial export return relative to cost level	Industrial export return relative to domestic market return	Domestic market return relative to inputs	GNP deflator in exports relative to (non-tradeable) domestic market
	(1)	(2)	(3)	(4)
1973	104.2	106.6	97.7	86.4
1974	102.8	107.3	95.8	69.3
1975	107.6	116.0	92.8	81.7
1976	106.3	117.6	90.4	93.8

NOTE: The source of columns (1) and (2) – Table IV-13 below; column (3) = column (1) divided by column (2); the source of column (4) – Table IV-11. The picture drawn by column (4) is different from that of column (2), but that is because the frame of reference of the two columns is different. Column (2) deals with industry only, and with the relation between product prices; column (4) deals with the whole economy and the relation between GNP deflators; because of this it requires a set of assumptions: the extent of the import component in exports as compared to domestic uses, as well as the extent that the rise in cost of imports is passed on in the domestic purchase inputs of exports (since it is necessary to deal with the entire import component). If the restraint of the economy does not allow this cost to be passed on, the calculation gives an exaggerated bias to the drop in relation, and to the following rise. In addition, one must remember the relatively low reliability of some of the national accounts included in column (4). The figures in column (2) are based on much more reliable data.

The decrease in investments is a natural and desirable phenomenon in the conditions of a restraint policy, especially when the restraint is intended to lead to structural change in the economy, and it does not harm long-term growth. But it is a component of short-term policy which must disappear after an interim, and not become part of the long-term solution.

The reallocation of resources that took place in the economy in the period under discussion has an acute significance concerning the balance of payments objectives. Any change from standstill conditions to a rapid course of growth will be accompanied by a considerable rise in imports (for current production, increase in stocks and expansion of investment). In order to achieve this transition without increasing the existing deficit (which is still much too high), most of the increment in domestic product will have to be allocated to export. In addition, the expected increase of investments will take its share, so that public and private consumption will receive only a small portion of the product increase.<sup>6</sup> This means a "marginal tax" (the absorption of income rise by means of taxation) of 80–90 percent or more.<sup>7</sup> In any situation this would be a difficult objective, and the difficulty is emphasized by the nature of the achievements of economic policy in recent years. It is reasonable to assume that a transition to a higher level of activity will make these difficulties more severe. Here the balance of payments constraint which keeps the economy at a standstill is clearly expressed: the inability to perform needed allocation changes (a significant decrease of consumption as a first step for renewed growth, or the absorption of the greater part of income rise after renewal of growth) means that the return of the economy to a course of growth will be accompanied by an increase of the deficit.

Another aspect of this constraint is the need for significant change in relative prices – in favor of foreign currency prices and against domestic prices. Such a change is difficult to achieve, and it is generally assumed to be possible only under conditions of economic restraint.

The developments in these two fields in recent years indicate that despite improvements there are still no definite signs of significant progress toward the primary goal: breaking through the balance of payments constraint, which prevents growth in the economy and leads to an ever increasing underutilization of production capacity. The developments and changes achieved so far have left us with the same basic dilemma, stagnation or increase of deficit.

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<sup>6</sup> In 1976 there was a small drop in real per capita income which did not cause a parallel drop in real consumption. It is possible that its effects will be felt in future, though the weight of this potential development is not great.

<sup>7</sup> Growth in savings is also possible, though the problem is too great for this to have much effect. Another means would be a drastic reduction of public consumption.

TABLE III-5  
ISRAEL'S TERMS OF TRADE FOR PRODUCT TRADE, 1969 TO 1976

	Import price index	Export price index	Terms of trade <sup>a</sup>	Import price index excluding diamonds	Export price index excluding diamonds	Terms of trade excluding diamonds <sup>b</sup>
Annual data (1969 = 100)						
1969	105.0	104.7	99.7	104.4	103.7	99.3
1970	105.6	104.4	98.9	106.7	103.5	97.0
1971	109.2	108.4	99.3	111.9	105.6	94.4
1972	115.8	116.2	100.4	118.0	109.9	93.1
1973	148.1	142.9	96.5	151.3	131.5	86.9
1974	202.9	169.1	83.3	212.3	167.5	78.9
1975	211.9	177.0	83.5	222.3	179.6	80.8
1976	206.8	180.2	87.1	215.6	178.0	82.6
Quarterly data (1973 = 100)						
1973 I	84.5	89.6	106.0	83.2	88.5	106.4
II	94.2	99.3	105.4	93.3	98.9	106.0
III	107.2	108.3	101.0	107.2	109.9	102.5
IV	114.3	106.3	93.0	115.8	108.0	93.3
1974 I	140.6	109.8	78.1	146.2	113.7	77.8
II	150.2	120.3	80.1	155.3	123.1	79.3
III	143.9	119.4	83.0	149.3	125.9	84.3
IV	144.6	120.7	83.5	153.3	131.0	85.5
1975 I	159.5	126.0	79.0	168.1	137.4	81.7
II	159.0	124.0	78.0	166.7	138.2	82.9
III	150.0	121.3	80.9	156.5	132.3	84.5
IV	146.0	121.2	83.0	152.1	130.7	85.9
1976 I	147.8	126.4	85.5	153.9	132.0	85.8
II	150.6	121.7	80.8	156.4	130.0	83.1
III	151.9	123.2	81.1	157.9	131.9	83.5
IV	156.3	129.7	83.0	163.9	136.6	83.3

<sup>a</sup> Export price index ÷ import price index.

<sup>b</sup> As the diamond price index is problematical from the statistical point of view, the terms of trade excluding diamonds have also been given.

## 2. THE CURRENT ACCOUNT

The main development in the current account in 1976 was a sharp drop in the deficit by \$800 million, from more than \$4 billion to \$3.3 billion. This decrease was achieved through a rapid rise in exports (13 percent in real terms) and a slight fall in imports (3 percent). Part of the decrease in the deficit results from a drop in defense imports. Excluding defense imports, there was a \$500 million decrease in the current deficit (more than 20 percent).

Part of the decrease in the deficit is a result of certain short-term factors, especially changes in inventory levels resulting from the adaptation to a new level of economic activity and from changes in expectations and financial profitability. The change in these factors may explain the decrease of about \$300 million in the import of inputs, and an increase of about \$100 million in the import of raw diamonds.

The lack of import growth was a major contribution toward improving the balance of payments. This was mainly the result of the economic restraint and the absence of growth since mid-1974. This influence can be clearly seen in the two main components of product imports: imported inputs (except for fuel and diamonds) fell by 5 percent as compared to 1975, while there was a slight rise (2 percent) of the level of total uses in the economy accompanied by a substantial growth (9 percent) in import needs for current inputs (on the average, the composition of uses became more import-intensive). This was largely due to the increased share of exports in total uses and to the growth of the average import component in it. There was an increase of only 2 percent in imported input requirements for domestic uses, which was in line with the overall increase in domestic uses. Imported input requirements for export rose by 31 percent, compared to an increase of 13 percent in exports. The 5 percent decrease in total import of inputs reflects the fact that 1975 was a year of stockpiling of imported inputs while in 1976 the reverse process — inventory liquidation — took place.

There was an 8 percent drop in the import of capital goods (excluding ships and aircraft) and a 10 percent decrease in imports of plant and equipment. This is a clear expression of the economic restraint and of its effect on profitability. It is important to note that the drop in imported plant and equipment is considerably smaller than the drop in investment of domestic equipment. This is reflected in an increase in the weight of imported equipment in total investments of equipment. This new development is typical of the period since 1973. It is not explained by the change of relative prices; it may possibly reflect a change in investment composition related to long-term factors. It may also reflect short-term influences: on the one hand, growing expectations of a relative appreciation of foreign currency and of import products (perhaps even of import limitations) due to the balance of payments situation; and on the other hand a considerable increase of the subsidy element in unlinked credit for investments in a time of steep price rises. Industry and agriculture are the main beneficiaries of this subsidy, and

the increased weight of these sectors in recent years is the main source for the increase in import intensity of investments.

Growth of exports results entirely from the export of goods. Here the increase in real terms reached 22 percent. This increase stands out even more in industrial exports (excluding diamonds, minerals and fuel) – 28 percent, and in agricultural exports (excluding citrus fruit) – 30 percent.

The turnabout in industrial exports, which occurred after four years of very slight increases (an average of 6 percent in the years 1972-75), mainly reflects two factors: on the one hand a considerable increase in world demand due to the economic recovery that began in the developed countries at the end of 1975 and accelerated in 1976; and on the other hand an economic restraint in Israel and the slackening of domestic demand in general, and of defense expenditure in particular.

It is difficult to make an unequivocal statement concerning the effect of profitability; different indicators do not give a homogeneous picture. The comparison of product price in export (and tradeable goods in general) to product price in nontradeable goods, shows a change in favor of tradeable goods in the last two years, but this increase only partially corrects for the considerable worsening of relative profitability in 1973-74, and the 1972 level has not yet been reached. The balance of payments situation requires that the change in favor of exports will considerably exceed the 1972 level. These comparisons deal with the economy as a whole and their accuracy and, in particular, the accuracy of the price data included in them, are limited, but this does not undermine the broad outlines indicated by them.

The picture of industrial export profitability is not as clear. The ratio index (input prices) between level of export prices and costs does not show a significant change in the last four years, although it is possible that a slight increase took place compared to the period before 1973. In any case this change was insignificant relative to the balance of payments objectives.

A comparison of the average price changes in industrial exports and in the domestic market shows a considerable improvement in exports. It seems that the main explanation for this is the existence of conditions of restraint in the economy, together with cost inflation, a situation expressed by a strong pressure on profits in the domestic market (see Table II-4). The relative profitability of export grew, of course, under these conditions but the durability of this change is conditional upon the continuation of restraint in the economy.

Against this background both the slow accumulating change of export growth during the last four or five years, as well as the absence of growth in the past six months, acquire great significance for several reasons; these developments should be viewed against the background of the economic restraint, the existence of a great surplus of underutilized production capacity, and an economic policy that gives priority to export stimulus.

The composition of export increase, which is connected with the problematical nature of export stimulus and the efficiency of this policy has already been noted. In this field sharp differences in trends can be seen: a considerable part of export increase originates from a relatively narrow segment of the industrial sector, namely defense exports. These exports have a very special character from many points of view, concerning both markets and the behavior of producers. Keeping in mind the great differences in the export performance of this sector and the industrial sector in general, the question arises, to what extent does the continued increase in defense exports reflect special conditions and to what extent is it the fruit of overall economic conditions, influenced by the economic policy. If the increase results mainly from the former, it shows the limited effectiveness of economic policy on export promotion.

The policy of the creeping devaluation is vital for the preservation of export profitability. As part of this policy, the exchange rate of the Israeli pound was raised at first in relation to the dollar through mid-year by 14.4 percent, and later in relation to a basket of currencies by 9.6 percent by the end of the year.

During the year the devaluation of the Israeli pound in relation to the main currencies reached an average of 24 percent. There was a 17 percent average drop in the exchange rate of the Israeli pound compared to 1975, caused by a higher average devaluation against the dollar (25 percent) which has been offset in part due to the rise of the dollar rate relative to other important currencies. The transition from defining the Israeli pound in terms of the dollar to a definition in terms of a basket of currencies should be seen in this context. This transition preserves a constant average exchange rate of the Israeli pound from one devaluation to another. This constancy was not possible under the previous arrangement where the exchange rate was fixed in terms of the dollar but floating in relation to all other currencies, and also in relation to their average. In the present framework, the exchange rate is constant relative to a weighted average of the currencies (represented in the basket) and floating in relation to the dollar.

### 3. THE CAPITAL ACCOUNT

The main development in the capital account in 1976 is the reduction of the current deficit to the level of long-term capital import totaling \$3.3 billion, similar to 1975. In this respect, the great gap which existed in 1975 disappeared. This manifested itself in a significant improvement in the capital account — the fast growth of dependence on short-term financing ceased. This growth had characterized the previous two years, when the economy's use of short-term financing reached \$2 billion. Nevertheless, dependence upon these sources remained at the same level that it had reached at the end of 1975. This change allows some breathing space for economic policy, but reduction of the dangerous dependence upon short-term sources is still one of the primary objectives of the economy.

TABLE

**FOREIGN EXCHANGE RESERVES AND NET**

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End of period	Foreign exchange reserves		
	At Bank of Israel	Deposits of other central monetary institutions	Total official reserve assets (1)+ (2) =
	(1)	(2)	(3)
1970	459	24	483
1971	732	36	758
1972	1,230	57	1,287
1973	1,810	169	1,979
1974	1,200	58	1,258
1975	1,184	165	1,289
1976	1,368	90	1,458
1972 I	1,021	40	1,061
II	1,085	41	1,126
III	1,108	36	1,144
IV	1,230	57	1,287
1973 I	1,445	77	1,522
II	1,519	145	1,664
III	1,607	144	1,751
IV	1,810	169	1,979
1974 I	1,648	131	1,779
II	1,416	124	1,540
III	1,145	77	1,222
IV	1,200	58	1,258
1975 I	1,489	48	1,537
II	1,481	60	1,541
III	1,237	49	1,286
IV	1,184	105	1,289
1976 I	1,150	94	1,244
II	1,214	94	1,308
III	1,316	86	1,402
IV	1,368	90	1,458

a The changes in the balances in this table are not the same as the changes in liabilities and assets of the banks shown in Table III-2. In the latter only changes from current transactions are shown, while in this table the reserves are influenced



## III-6

FOREIGN LIABILITIES OF ISRAELI BANKS, 1970-1975<sup>a</sup>

million)

Liquid foreign obligations of banks		
Deposits in foreign banks	Liquid obligations to foreigners	Net liquid foreign obligations (5) - (4) =
(4)	(5)	(6)
369	631	262
677	986	309
1,134	1,343	209
1,328	1,742	414
1,246	2,166	920
1,225	2,690	1,465
1,368	2,937	1,569
719	1,039	320
637	912	275
818	1,045	227
1,134	1,343	209
1,162	1,359	197
1,223	1,536	313
1,347	1,855	508
1,328	1,742	414
1,408	1,696	288
1,298	1,708	410
1,155	1,608	453
1,246	2,166	920
528	2,077	1,252
839	2,031	1,192
937	2,089	1,152
1,225	2,690	1,465
1,089	2,412	1,323
1,129	2,491	1,362
1,167	2,588	1,421
1,386	2,937	1,569

by changes in foreign exchange rates as well as other changes which do not result from current transactions (as the closing of the Israeli-British Bank).

In long-term capital import the same trends that characterized 1975 remained. The principal fact was the great dependence upon financial aid from American sources, whose weight reached 52.3 percent of all transfers and long-term loans (52.9 percent in 1975). This followed a steep rise from an average level of 19 percent during 1971–1972, and a level of 8 percent in 1969. This increase paralleled the steep rise in defense imports, from a level of \$250 million in 1968 to about \$500 million in the years 1971–1972, reaching \$1.6–1.8 billion in the last two years.

There was a positive change from 1975 in the composition of capital import: a considerable increase in the weight of unilateral transfers (from \$1.9 to \$2.2 billion) and a decrease in the weight of loans (from \$1.5 to \$1.0 billion). This reflects mainly a change in the composition of American aid; here there was a considerable increase in the weight of unilateral transfers – from 35 percent to 69 percent – while in the total of all other transfers there was a general drop: an increase in Jewish Agency and nonprofit institution transfers (from \$510 to \$540 million), which was outweighed by a decrease in private transfers (from \$640 to \$590 million). This continues the trend of previous year. The increase in transfers to institutions is small in real terms, but probably reflects the improvement of economic conditions of the contributors abroad.<sup>8</sup>

The decrease in private transfers continues a trend of recent years. The drop in transfers of German restitutions, after years of continuous increase, is due to the completion of many cases involving one-time payments. Pension payments continued to rise, while other private transfers continued to fall at considerable cumulative rates: the real decrease in comparison with 1972 reaches 60 percent in the general total, and 85 percent for immigrant transfers. This decrease reflects the effect of the restraint of economic activity, and a decrease in profit expectations in the economy, and expectations for devaluations due to the balance of payments problem. The combinations of these factors also explains the steep cumulative drop in investments from abroad.

Despite the outstanding improvement in the deficit situation (the closing of the gap between long-term capital import and the current deficit), resort to short-term capital from abroad continued, though to a lesser extent than in 1975 (see Table II-2). This rise in short-term financing was mainly expressed by an increase of the foreign currency reserves of the Bank of Israel and did not create a net increase in short-term liabilities from foreign sources.

The picture of events in this area is incomplete and unclear. There is no information on the use of one central instrument – exchange rate guarantees from the Treasury for

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<sup>8</sup> The data are based upon classifications in the balance of payments, and may be misleading, because money raised by the Jewish Agency abroad as loans is entered as unilateral transfers. In 1975, which was a year of world recession, there was a considerable increase in transfers of the Jewish Agency, which was partly the result of a mobilization of capital loans due to Israel's balance of payments difficulties. Part of the real increase in income of the UJA in 1976 was used for repayment of loans taken in previous years.

foreign loans — a factor whose influence drastically changes all calculations of the relative advantages of various financial and real assets.<sup>9</sup>

Nevertheless, the general outlines of various activities can be pointed out. Concurrent to the drop in additional short-term credit from abroad, a considerable change took place in 1976 in its sectorial composition: there was a sharp drop in credit granted to the government, and the balance shrank, while there was a slight rise in credit to the private sector compared with the increase in 1975. Part of the increase in 1976 resulted from a change in the institutional framework: the regulations regarding short-term credit were changed, and the banks were allowed to use financial resources from abroad to grant credit to exporters within the framework of the Export Shipments Fund. This means that the short-term accumulation of assets abroad is balanced by a parallel accumulation of short-term liabilities abroad, instead of a decrease in other assets (the reserves of the Bank of Israel). Discounting the influence of this factor, the increase of credit for the private sector was a little lower than in 1975.

The increase in the balance of short-term credit coincided with a slight drop in imports and with a drop — apparently quite significant — in the stock of import products. Thus, a certain change in the composition of the private sector's assets towards an increase of net foreign liabilities<sup>10</sup> can be seen. This evaluation is based on a partial picture and mainly deals with short-term rather than the long-term components of assets, in which a reverse trend is possible. This development must be seen against a backdrop of changes in interest differentials and exchange rate expectations: an increase in rates of interest in the Israeli economy in contrast with the continuing decrease in the world money markets, an apparent weakening of expectations of devaluation due to the improvement in the balance of payments, adaptation to the creeping devaluation as a fact of life, and the nearing of elections.

A parallel change took place in the allocation of financial resources of the banks: the net foreign liquid liabilities only increased at a low rate (perhaps reflecting the ability to mobilize further financial resources by Israelis abroad, but the banks decreased assets abroad (loans to companies abroad, especially those connected with the Israeli economy). This gave them sources for credit expansion in foreign currency to the domestic private sector.

The picture drawn above in broad outlines shows the sensitivity of the movements of short-term capital to changes in the evaluation of relative profitability while the expectation of a large devaluation overshadows all other factors.

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<sup>9</sup> This factor also influences long-term loans from abroad and their possible substitution for short-term credits.

<sup>10</sup> Stock import, for our purposes, can be seen as a substitute for assets abroad.