CHAPTER VI

ISRAEL AND THE WORLD ECONOMY

1. MAIN DEVELOPMENTS

In 1975 the world economy reached the trough of its most serious recession since World War II and began to recover. In all major industrial countries, except the U.K., the second half of the year saw a shift from a negative to a positive growth of real gross national product, with the U.S. and Japan in the lead[1] and Europe generally lagging one or two quarters.[2]

Developments in the Israeli economy both complemented and contrasted with this trend. As in other countries, both exports and GNP weakened in mid-1975 (although the break in GNP was less sharp than in the larger industrial nations). However, a mild recovery in late 1975 was held back, mainly because of deliberate policy measures induced by concern over Israel's severe balance of payments problem, which in glaring contrast to the average of the industrial countries, did not improve this year.

A second notable development in 1975 was the general marked deceleration of inflation. For OECD members (constituting most of the industrialized world) the annual increase in consumer prices slowed from 13.2 percent in 1974 to 8.4 percent by the third quarter of 1975. Again, the U.K. was the only major exception to this downward trend, and the best performances were registered by the U.S. and Japan.

The basic causes of this slowdown--the one-shot character of the OPEC price revolution of 1974 plus the moderating effects of the recession on commodity prices and prices in

1. As noted below, the Japanese recovery appeared to falter in the last quarter of 1975.
2. At the time of writing this chapter debate continues as to the probable speed, and especially the durability, of the upswing (some causes for doubt are noted below). But that there was a strong initial recovery in late 1975 and early 1976 is certain.

general--affected Israel in common with all other countries. Thus, the Israeli price advance also lost momentum in 1975. But there was a reversal in the latter part of the year, owing to the new policy of mini-devaluations, which, like the policy of demand restriction, was motivated by concern over the country's balance of payments.

Table VI-1

GROWTH OF REAL GNP IN OECD COUNTRIES, 1960-75

(percent change at annual rates)

	Average 1960-72	1974	1975	1974 2nd half	1975 1st half	1975 2nd half	1975 4th qtr.
Canada	5.1	2.8	-1.0	-0.5	-2.7	2.0	
U.S.A.	4.2	-2.1	-3.0	-3.7	-7.7	8.0	5.0
Japan	10.9	-1.8	1.25	3.1	-0.2	2.75	
France	5.9	3.9	-2.0	-0.1	-5.0	2.5	7.0
W. Germany	4.9	0.4	-3.4	-2.8	-7.1	3.3	13.2
Italy	5.6	3.2	-4.5	-6.7	-5.8	0.75	7.0
U.K.	3.3	0.1	-2.25	5.6	-5.0	-3.75	
Total above countries							
Weighted by OECD							
Weighted by Israel's exports (1972)	5.5	-0.6	-2.25	-1.7	-5.8	4.5	
		-0.3	-2.4	-0.8	-5.7	3.4	
Other OECD countries	5.5	2.7	-1.0				
Total OECD							
Incl. U.S.A.	5.5	-0.1	-2.0	-1.7	-5.1	3.75	
Excl. U.S.A.	6.4	1.3	-1.5	-0.4	-3.4	1.0	

SOURCE: OECD countries — Organization for Economic Cooperation and Development, *Economic Outlook*, December 1975; West Germany — Deutsche Bundesbank, *Monthly Report;* data for the fourth quarter of 1975 for France and Italy are estimates of the First National City Bank of New York.

On a third front, that of international payments and terms of trade, 1975 witnessed, on a world scale, a dramatic if still only partial turnabout. The OPEC-induced massive growth of the current deficit of the industrialized nations (mainly the OECD group) was virtually wiped out in 1975 (see Table VI-8), as OECD countries greatly stepped up their exports to the OPEC and, because of their own recession, reduced imports from all countries. Thus, some of the improvement in the OECD payments balance came at the expense not of the OPEC surplus, but of a further deterioration in the adverse balances of the developing nations (and the communist bloc). This was largely due to the slump in the OECD area, since the developing and communist areas are oriented toward exports to the OECD countries, while these were in the best position to supply the greatly increased demands of the OPEC countries for sophisticated industrial and military goods.[3]

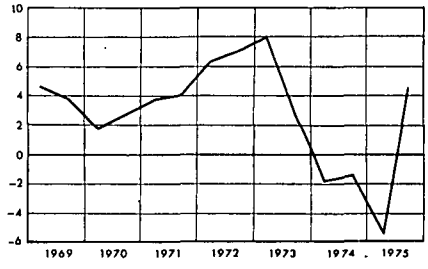
3. 1976 should provide an empirical test of the damage done to the developing countries' trade balances and terms of trade by the OPEC price revolution alone, as opposed to the Western economic recession.

The terms of international trade (i.e. the export-import price ratio), which had undergone a revolution in 1974 in favor of OPEC, showed a reversal of trend (albeit milder) in 1975 (see Table VI-10). The terms of trade of the industrial nations (especially those whose exports consist mainly of manufactures--e.g. Western Europe) rose; those of the oil exporters declined slightly (for the first time in several years); while the nonoil developing countries experienced a further erosion.

Figure VI-1

GROWTH OF REAL GNP IN SEVEN MAJOR OECD COUNTRIES, 1969–75

(percent change from previous half-year, at annual rates)



SOURCE: Table VI-1.

Israel shared in these developments to the extent of greatly boosting overseas sales to the (non-Arab) oil exporters. But this market is very small. Because of the sharp break in import demand in the developed countries (Israel's main customers), combined with the failure of Israel's import demand to drop very much, this country was able to improve its trade deficit in 1975 only fractionally. On the other hand, the heavier defense and interest burden added to the deficit.[4] In terms of trade too Israel

Table VI-2

CONTRIBUTIONS TO CHANGES IN REAL GNP, HALF-YEARLY, 1974–75

(as a percent of GNP in previous period; annual rates)

	U.S.A.			W. Germany			Japan			7 major countries[a]		
	1974	1975		1974	1975		1974	1975		1974	1975	
	II	I	II	II	I	II	II	I	II	II	I	II
Private consumption	-0.8	-0.5	4.0	0.9	1.2	1.5	2.5	2.0	2.0	0.1	0.3	2.5
Public expenditure	0	0.6	0.5	0.3	0.4	0.5	1.0	2.2	1.0	0.3	0.9	0.5
Private residential construction	-1.0	-1.1	0.75	-1.0	-0.8	-0.25	1.0	-0.6	1.0	-0.5	-0.8	0.5
Private nonresidential investment	-1.1	-2.4	-0.5	-0.8	-1.7	0.75	-2.1	-1.6	-0.75	-1.1	-2.0	-0.5
Stockbuilding	-0.3	-5.5	3.5	0.9	-1.2	1.0	-2.4	-4.2	0.5	-0.6	-4.9	2.0
Foreign balance	-0.4	1.1	-0.25	-3.0	-5.1	-1.5	3.1	2.0	-1.0	0.1	0.8	-0.75
GNP	-3.7	-7.7	8.0	-2.8	-7.2	2.0	3.1	-2.0	2.75	-1.7	-5.8	4.5

[a] U.S.A., W. Germany, Japan, France, U.K., Italy, and Canada.
SOURCE: OECD *Economic Outlook*, December 1975, Table 4.

4. As noted, this contrasted with the sharp average reduction in the trade deficits of the industrial countries. Much of the difference lay in the steep fall in imports abroad as opposed to relatively constant imports by Israel (especially of production inputs--see Chapter IV).

did not fare well in the year reviewed. Instead of recovering (like the industrial countries) from one-quarter to half the ground lost in 1974, there was a slight further retreat on a year-to-year basis (although it was checked in the second quarter and the trend has turned up since then). In this respect Israel's performance has resembled that of the raw-material oriented nations more than that of the industrialized states, although the structure of its trade is more like that of the latter group.[5] This calls for an explanation, and we discuss it further below.

As to international capital flows and exchange markets, 1975 witnessed a considerable alleviation of the previous year's anxieties about the recycling of oil revenues and, to a lesser extent, the effects of floating exchange rates. The international banking system did not collapse, as some had feared, under either of these unfamiliar strains. Although floating rates sometimes exhibited nervous excessive fluctuations, their main effect was to forestall the massive swings in speculative funds which could easily have been induced (under fixed rates) by the sharp cyclical disturbances to equilibrium in the international economy. Where important speculative flows did occur, they tended to be concentrated in

Table VI-3

GROWTH OF ISRAEL'S EXPORT MARKETS,[a] 1973–75

(percent change, at annual rates)

	1973[b]	1974[c]	1975[c]	1974[d] II	1975[d] I	1975[d] II
Weighted by total Israeli exports, incl. diamonds						
Developed countries	11.1	0.3	-8.8	-1.4	-19.3	8.3
Other countries	16.6	15.0[e]	11.7[e]			
Total	**12.6**	**4.4**	**-2.5**			
Weighted by total Israeli exports, excl. diamonds						
Developed countries	10.3	0.1	-8.3			
Other countries	14.8	15.6	17.3			
Total	**11.6**	**4.9**	**0.4**			

[a] The measure of market expansion is the rate of increase in the total imports of the countries of destination, weighted by each country's share in Israel's exports, either including or excluding diamonds.
[b] 1972 weights.
[c] 1974 weights.
[d] Based on nine of the 15 developed countries.
[e] Reflects the much heavier import by the oil producing countries such as Iran.
SOURCE: Import data — Developed countries: OECD, *Economic Outlook;* other countries: OECD, *Economic Outlook,* and IMF, *International Financial Statistics.* Israeli export data — Central Bureau of Statistics.

5. For example, in 1973 a U.N. breakdown showed that the share of industrial exports in the developing economies was 24.5 percent (raw materials and food 75.5 percent); in the developed economies it was 74.5 percent (this average was dominated by the IMF industrial group); and in Israel it came to 75 percent.

Table VI-4

SUMMARY OF WORLD TRADE CHANGES, 1973-75

(percentages)

	1973	1974	1975		
			Entire year	1st half	2nd half
World trade volume[a]	13	6	-6		
Import volume					
Industrial countries	12.5	1	-9	19.0	6.1
Other developed countries	15	7	-5.5	-10.3	2.0
Major oil exporters	23	45	48.5	48.4	27.7
Other developed countries	15	14	-8	-10.5	-20.1
Industrial countries					
Export markets[b]	13.8	6.4	-5.0	-12.3	2.1
Export volume	13.9	7.9	-5.7	-11.5	1.0
Import volume	12.5	1.0	-9.1	-19.0	6.1
Real GNP, trade-weighted	5.8	1.1	-2.1	-4.9	2.2

[a] Average rates of increase in world exports and imports (excluding the communist countries).
[b] Average change in the imports of the other groups of countries, weighted by the share of each group in the industrial countries' 1974 exports.
SOURCE: International Monetary Fund.

exchange rates which retained a significant degree of pegging or informal intervention, such as those of the EEC "snake".

2. SOURCES OF CYCLICAL CHANGE IN 1975

The stage was set for recovery in 1975 mainly by the working-through of the cost-push effects of the commodity and oil price booms of 1973 and 1974.[6] Since these pressures were generally not accommodated by expansionary monetary or fiscal policies but, on the contrary, occurred at a time of tightening policies originally directed mainly against demand inflation (and later against growing payments deficits as well), they greatly deepened the cut in real activity throughout the industrial world. Once this had taken place, and with a cessation and partial reversal of the cost-push pressures (commodity prices fell while the rise in oil prices slowed to a crawl), equilibrium was restored between the money stock and the level of real economic activity.[7] Thus, as the price

6. Although they were superimposed upon an earlier inflationary rise in demand, these price increases are described as "cost-push" because of their clearly excessive effect upon the aggregate price level in a world economy characterized by a downward rigidity of wages and many other prices.

7. The fact the new "oil" deficits shrank (more quickly than expected) because of increased imports by OPEC countries helped the process of recovery, both directly (through its effect on real demand) and indirectly, by removing obstacles to a strong policy of demand reflation.

advances subsided, a larger part of the nominal demand growth could again find expression in higher rates of real growth. In addition, in late 1974 and early 1975 policies swung around toward expansion. The U.S. conducted a strongly stimulative fiscal policy, while monetary policy remained tight. In other countries both monetary and fiscal policies became expansive in 1975.

(a) *U.S.A.*

In the U.S. the turnaround took a particularly dramatic form. A long period of very low consumption and negative investment growth in 1974 failed to evoke a full response in current production or employment, and inventories tended to accumulate slowly. Hopes for an early recovery were not really dashed until a drastic break occurred in real final demand (entirely in private consumption) in the last quarter of 1974.[8] This induced an uninhibited cutback in production and in inventories (and a steep rise in unemployment), which carried over into the first quarter of 1975. By the second quarter most of the desired destocking had been accomplished and, since incomes and final demand were not only maintained by unemployment compensation but stimulated by income tax cuts, a continuation of the negative growth rate of the previous quarters was virtually impossible. Thus the stage was set for the extraordinary (and obviously temporary) 11.9 percent annual growth rate of the third quarter. Essentially, this reflected the change from drastic negative to near-zero inventory investment, while real final demand carried on with a much less dramatic growth rate of about 4 percent.

The weakest point in U.S. recovery has been the sluggish expansion of the money supply. The 4.4 percent rise (in M_1) during 1975 fell well short of even the 5-7 percent goal of the monetary authorities. Moreover, the trend sagged noticeably from mid-1975 through the beginning of 1976 (with the slowdown in massive government bond issues and the failure of business borrowing to rise as expected). To some extent this factor was offset by the strengthening of the dollar after mid-1975 (by about 7.5 percent). This slightly retarded the internal price advance, and thus expanded the real money stock in the same way as a somewhat faster growth of the nominal money stock would have.[9]

The actual advance in prices and in nominal GNP relative to the nominal money stock and the consequent fall in real M cast some doubt on the average trend of the recovery in 1976

8. This primarily took the form of a steep increase in the rate of private saving, which may have been more than coincidentally related to the heavily publicized decision (in the fall of 1974) to emphasize anti-inflation rather than counter-recession economic policy--an approach which was quickly reversed in early 1975.

9. The magnitude of this effect on prices calls for further study. It would be about 1 percent if based upon the weights of U.S. exports and imports, but it might be

(and later), although this also depends upon other factors, especially price increases, which are difficult to predict. A second potential source of trouble, somewhat further down the road, is the possibility of a renewed commodity price boom which, if it meets the same reaction as in 1973 and 1974, will tend to produce similar consequences.[10]

(b) *Europe and Japan*

Table VI-2 permits us to distinguish some important variations in the cyclical process and thus major structural characteristics of the world recession which deserve attention. In particular, a breakdown of real demand changes affecting the German economy helps us to understand why a relatively expansionary monetary policy (introduced in 1974) in this country resulted, on the whole, in little obvious edge over the U.S. growth performance in 1975. The significant difference between the two countries lay in the contribution of inventory liquidation and trade balance changes to the economic slowdown in the first half of 1975. The loss of exports (due mainly to the recession elsewhere, but partly to the accumulated effect of earlier revaluations of the Deutsche mark) accounted overwhelmingly for the slowdown in Germany, whereas internal inventory liquidation claimed the lion's

Table VI-5

RISE IN OECD CONSUMER PRICES, 1974–75

(percent change, at annual rates)

			1975			
	1974	1975	I	II	III	IV
Canada	10.9	10.8	8.9	9.0	14.4	8.5
U.S.A.	11.0	9.1	7.4	6.4	9.0	6.4
Japan	24.4	11.7	6.5	14.5	4.0	9.6
France	13.7	11.7	11.4	10.2	9.1	**9.1**
W. Germany	7.0	6.0	7.9	7.8	3.0	3.6
Italy	19.1	17.2	12.8	11.1	8.8	12.6
Netherlands	10.0	10.2	8.7	11.7	8.2	9.2
U.K.	16.0	24.1	26.7	41.8	18.9	14.5
Total OECD	13.2	10.4	8.8	11.6	8.4	11.9

SOURCE: 1974–75: OECD, *Economic Outlook*; quarterly data for 1975: OECD, *Main Economic Indicators*.

considerably more if the weight of all tradable goods is considered. It should be understood, however, that the stimulative effect of a fall in the exchange rate works through its reduction of the actual rise in the price level. This rise is known, and was, despite this effect, well above the increase in M_1. In fact, nominal GNP expanded about 9 percent during 1975, as against only 4.4 percent for M_1 in 1975 and 5.3 percent in 1974.

10. It is to be hoped (but the outlook is still very uncertain) that stockpiling arrangements currently in process of negotiation (e.g. at the UNCTAD conference in Nairobi) and recent investment in commodity industries will bear fruit. In the short run supplies are ample, but the marked instability of demand has tended to destabilize investment as well.

share in the U.S. and almost everywhere else. Domestic demand, which may be expected to show the main effect of monetary policy, fell much less drastically in Germany than in the U.S. Since the German recession was much more export-led, the rebounding of the economy in the second half could hardly have been as strong as in the U.S., as trade balances are inherently less volatile than changes in inventory investment.[11]

In Europe and Japan, as in the U.S., one may detect the dampening effect of sluggish credit demand on monetary growth. Yet, notwithstanding this impact, most of these countries, including Germany, France, and others, managed to boost their money stock growth rate to a much greater extent than the U.S. (see Table VI-7).

In 1975 as a whole the monetary growth rate (M_1) in all other major economies was four times as great as that of the U.S. (while price inflation was similar to or double that of the U.S. level, except for the U.K.). In all European countries (apart from the U.S.) real money balances (i.e. M_1/nominal GNP) rose during 1975, and in most they continued upward even in the fourth quarter, despite the renewed growth of real GNP.

Table VI-6

CHANGES IN WAGES AND EXPORT PRICES IN SEVEN MAJOR OECD COUNTRIES, 1974-75

(percent increase over previous year)

	1974			1975		
		Export price index[a]			Export price index[a]	
	Hourly earnings	Local currency	SDR	Hourly earnings	Local currency	SDR
Canada	13.5	32.7	34.8	14.0	11.4	5.9
U.S.A.	8.1	27.7	26.6	8.0	11.9	10.7
Japan	26.6[b]	39.0	28.3	15.0[b]	2.9	0.3
France	18.6	24.4	13.7	15.0	8.1	19.5
W. Germany	10.6	14.8	16.6	8.25	8.0	12.7
Italy	22.4	41.7	25.6	24.0	12.4	11.3
U.K.	17.1	26.5	19.6	28.0	21.4	14.3
All industrial countries (incl. smaller ones)[c]		26.4	23.3		9.4	11.3

[a] Unit values.
[b] Monthly earnings.
[c] Weighted by export values in SDRs.
SOURCE: Export prices — IMF; wages — OECD, *Economic Outlook*, December 1975.

11. It might be argued that, in view of the need to cut its huge trade surplus while substituting adequate domestic demand, Germany should have pursued an even more expansionary policy. But given the uncertainties of trade forecasts, it would be more reasonable to argue that other countries (not only the U.S.) should have followed a more stimulative policy.

Fiscal policy in most countries, as noted, also contributed to the recovery in 1975. It acted both as the catalyst of monetary growth (which was usually accomplished by financing larger fiscal deficits through money creation) and as a direct stimulus to aggregate demand (mainly by increasing private disposable incomes and consumption by more than it tended to reduce investment expenditure as a result of government competition with the private sector in the capital market).

According to OECD calculations, net reductions in taxation (or increases in transfer payments) added almost 4 percent to disposable income in the U.S., over 5 percent in Germany, about 2 percent in France, but only 1.4 percent in Italy and Japan, while fiscal drag still subtracted 1.6 percent in the U.S. Most of these increases required discretionary action, as the failure of built-in tax stabilizers to move promptly against a "real" recession accompanied by extraordinary price inflation was one of the special features of the 1974-75 cyclical experience.

Table VI-7

GROWTH OF MONEY SUPPLY (M_1) IN SELECTED COUNTRIES, QUARTERLY,[a] 1974-75

(quarter-to-quarter percent changes, seasonally adjusted, at annual rates)

	1974					1975				
	I	II	III	IV	1973 IV to 1974 IV	I	II	III	IV	1974 IV to 1975 IV
U.S.A.	6.1	5.7	4.3	4.1	5.0	0.6	7.6	7.3	3.0	4.4
W. Germany	7.1	7.9	14.1	13.6	10.6	10.5	16.1	18.6	21.5	16.0
France	11.6	15.5	1.4	28.2	13.8	5.1	1.0	26.1	21.0	16.0
U.K.	-11.7	8.8	18.8	33.0	18.4	8.8	30.5	26.5	-5.0	16.0
Italy	16.5	17.9	8.2	4.8	11.7	10.9		0.0	14.0	8.5
Japan	14.3	18.4	6.4	5.7	11.1	13.2	10.1	14.4	2.5	12.5
Netherlands	4.0	5.9	11.0	18.7	9.8	12.0	31.4	34.0	-3.0	22.0
Belgium	9.5	8.7	3.6	12.0	8.4	10.5	16.2	16.0	—	—
Switzerland	-9.2	5.1	-5.4	-1.9	-3.0	7.2	6.5	-3.6	—	—

[a] Change in quarterly averages of monthly data.
SOURCE: 1974-75 III — Federal Reserve Bank of St Louis; 1975 IV (approximately) — *The Economist.*

Japan appears to present a rather special and interesting case of a recovery which was temporarily aborted to a significant degree by monetary stringency. The aggregate figures for GNP and industrial production show an accelerating fall from late 1973 until the first quarter of 1975, which was clearly the trough of a steep inventory liquidation. In the second quarter both series turned up strongly (e.g. industrial production expanded at a 17 percent annual rate in the second quarter after a 30 percent drop in the first). The advance continued in the third quarter, although at a slower pace, but was suddenly

braked, and even slightly reversed, in the fourth quarter (although growth appears to have been renewed since January 1976). The picture is one of an output recovery (consisting largely of production for stock) based on hopes of a stronger rise in final demand than actually took place. This rise was apparently prevented mainly by the persisting effects of the monetary restriction on domestic demand and the more immediate effects of the recession abroad on exports.[12]

(c) *Israel*

Israel's economic performance in 1975 continued to be dominated by policies designed almost exclusively to cope with the intensified balance of payments problem by reducing the current deficit. This motivated a deliberate policy of retarding real GNP growth. To achieve the payments target and the requisite dampening of real growth, several measures were employed, even though they directly drove prices up still further. The principal ones were indirect tax hikes and devaluations. These measures and even a nominal wage increase, while pushing up costs, helped to slow the monetary expansion engendered by government deficits and other pressures (influenced, of course, by nominal wage agreements, etc.), which might otherwise have stimulated a much faster real growth.[13]

Nevertheless, Israel's recession in 1975 was more moderate than average, and the increase in overt unemployment was distinctly below par. It avoided (in 1975 at any rate) the sharp break in demand and the subsequent steep inventory cycle that characterized the larger industrial economies (with the partial exception of Germany, as noted above). To some extent this was due to the smaller number of hours worked per employee and other forms of hidden unemployment, as well as demand-related factors depressing the labor supply.[14] The evidence suggests, however, that the balance in this respect was precarious, and a more serious slump in demand, employment, and production was (and remains) a distinct possibility. In the final months of 1975 there were signs of an upturn, fueled by both domestic and export demand.

12. Monetary growth slowed even more sharply than price inflation until the third quarter of 1975 (despite fluctuations due to credit demand), and especially during 1974. Official monetary policy was supposed to be eased in mid-1975 (by lowering interest rates from 9 to 6.5 percent), but this hardly adjusted nominal interest rates to the sharply decelerating price inflation.

13. These measures of course differed in other significant respects. Devaluation and indirect taxes tended to improve the trade balance by raising the relative prices of imports and exports, reducing private income and consumption, and (like wage increases) dampening real monetary growth.

14. See Chapter XII for a detailed discussion of both the demand- and supply-related factors.

3. WORLD TRADE AND PAYMENTS BALANCE IN 1975

The tables in this chapter detail various aspects of Israeli and international trade and capital movements in 1975. The most crucial data are summarized in Table VI-4, which shows an extraordinary fall in the volume of world trade that year (actually more unique than revealed by the table--it was the deepest slump in trade in the entire post-World War II period). Apart from the sheer size of the decline, its most interesting aspect was the disproportionate relation to the downturn in real GNP. As may be seen from Table VI-4, in the first half of 1975 the industrial countries experienced a 19 percent drop in import volume, as against a 4.9 percent decline in real GNP.

Although this divergence is extraordinarly large, it is important to understand that disproportionality between cyclical changes in GNP and in imports is the rule rather than the exception.[15] This is reflected in the other figures in the table. (The elasticity is somewhat obscured by the fact that the trend relation of imports and GNP is well above unity for the industrial countries as a group, although not for Israel.) The exceptional depth of the import drop in 1975 is explained partly by the substitution effects of the steep relative price rise of imported goods (especially oil) in 1973 and 1974 and partly by the particular importance of inventory changes in the 1975 cycle. As may be seen from the tables, complementary changes took place in the trade volume and trade prices (terms of trade) of the various country groups (classified roughly according to their

Table VI-8

WORLD CURRENT ACCOUNT, 1974–75

($ billion)

	Excl. official transfers			Incl. official transfers		
	1974	1975	Change	1974	1975	Change
OECD	-22.5	6	28.5	-33.25	-6	27.25
OPEC	68.5	46.5	-22	67	43	-24
Nonoil developing countries	-26	-38	-12	-17.5	-27	-9.5
Other[a]	-10.5	-15	-4.5	-10	-14.5	-4.5
Discrepancy	9.5	-0.5		6.25	-4.5	

[a] Sino-Soviet area, South Africa, Israel, Cyprus, Malta, and Yugoslavia.
SOURCE: OECD, *Economic Outlook*, December 1975, Table 29.

15. This has been statistically verified for many nations, including Israel. It is reflected in the forecasts for a 1976 import recovery (by the IMF, OECD, etc.), which envisage a rise in imports about twice that of GNP over 1975 (roughly 6.5 vs. 3.5 percent).

Table VI-9

COMPONENTS OF TRADE BALANCE CHANGES IN SEVEN MAJOR OECD COUNTRIES, 1974-75

($ billion)

	Changes from 1973 to 1974 due to:				Changes from 1974 to 1975 due to:		
	Volume	Oil price	Other terms of trade	Total	Volume	Terms of trade	Total
Canada	-4	0.75	2	-1.25	-1.5	-1.25	-2.75
U.S.A.	8	-17.25	3	-6.25	12	3.5	15.5
Japan	7.5	-14	4.5	-2	7.5	-3.5	4
France	2.75	-6.75	-.75	-4.75	3.75	2.25	6
W. Germany	8.5	-7.5	5.75	6.75	-11	7	-4
Italy	3.75	-5.25	-3	-4.5	7	0.5	7.5
U.K.	1.25	-6.25	-1.75	-6.75	2.5	2.75	5.25
Total OECD	25.5	-68	8.5	-34	24.25	9.5	33.75
Of which:							
1. with OPEC	9.5	-62.5	3	-50	23.5	-4.5	19
2. with nonoil developing countries	8	-2.5	-0.5	5	5	8.75	9.25
3. with other non-OECD countries	6	-3	2.75	5.75	0	5.25	5.25

SOURCE: OECD, *Economic Outlook*, December 1975, Table 26.

specialization in international trade). Thus, the industrialized countries continued to strongly expand their exports to the OPEC group (while reducing their imports of oil more moderately). They also sharply reduced their imports from the raw-material exporting developing countries (see Table VI-9). Changes in prices (and thus in terms of trade) followed these shifts in demand pressure. Industrial export prices rose relative to those of oil (although the latter were still subject to a bit of cartelized cost-push) and, more drastically, relative to other more competitively supplied raw materials. Thus the terms of trade of the industrial countries improved significantly, those of OPEC declined slightly, and the raw-material exporting countries (including not only the developing countries but even such advanced countries as Canada) experienced a marked deterioration (see Table VI-10).

Israel's performance in this area (trade volumes and terms of trade) was unsatisfactory in several respects. True, its exports fared better than the market trend (i.e. they expanded slightly despite an absolute reduction in aggregate import demand among its trading partners--see Table VI-3). This was to be expected in view of previous policy efforts. But the drop in its imports was definitely below par in relation to the extraordinary negative growth of the country's real demand.

Table VI-10

TERMS OF TRADE CHANGES IN SELECTED COUNTRIES AND GROUPS, 1973-75

(percentages)

				Unit value of exports (SDR)		Unit value of imports (SDR)	
	1973	1974	1975	1974	1975	1974	1975
U.S.A.	-1.9	-13.8	2.1	26.6	10.7	46.9	8.5
Japan	-3.9	-20.4	-6.1[a]	28.3	0.3	61.2	6.9
France	2.0	-15.7	4.9	13.7	19.5	34.8	13.9
W. Germany	-3.0	-8.2	7.4	16.6	12.7	26.8	4.9
Italy	-8.7	-17.9	4.4	25.6	11.3	53.0	6.6
U.K.	-9.3	-14.9	8.1	19.6	14.3	40.6	5.8
All European countries	-2.7	-10.8	4.8	20.3	13.9	34.8	8.7
All industrial countries	-2.0	-11.2	2.6	23.5	11.5	39.0	8.5
Other developed countries	10.3	-13.8	-5.5	24.5	3.5	44.5	9.5
Major oil exporters	16.2	147.0	-6.1	207.0	4.0	24.5	11.0
Other developing countries	6.3	-4.3	-12.2	32.5	-4.0	38.5	9.5
Israel		-18.0	-2.2	16.0	3.0	41.0	5.5

[a] Connected with the extreme slowdown in price inflation and the devaluation of the yen, which permitted stable export prices (in foreign currency) while import prices continued to rise.

SOURCE: Israel — based on CBS Laspeyres indexes; other countries — International Monetary Fund.

Imports sagged at about the same rate as real demand, rather than following the disproportionate relationship to changes in cyclical demand noted above. Further, we find that after the unprecedented decline in Israel's terms of trade, followed by a short-lived upswing in 1974 (see Table VI-II), they turned sharply downward again in the first half of 1975, and only began to recover in the second half of the year.[16] The figures reflect several developments (e.g. the strengthening of the dollar against European currencies in the second half of 1975, which tended to lower both export and import prices in dollar terms, and the differential between what the government paid for commodity purchases in the forward market and world market spot prices).[17] Nevertheless, the fact that Israel's terms of trade deteriorated more than average in 1974 and fell short of the average improvement in 1975 gives rise to some suspicion of a possible distortion in the data. There may have been a tendency to exaggerate import prices (figures for consumer durables look especially high) and to understate export prices (e.g. diamonds in 1975).[18] This may

16. The steeper decline in Israel's term of trade in 1974 compared with the industrial countries was accounted for by the flattening of diamond and citrus prices while world industrial prices rose 25 percent or more. In 1975 citrus prices turned up, but diamonds continued to stagnate and prices of other industrial exports went up at only half or less the average rate for the industrial countries. To some extent this reflected Israel's devaluations.

17. Another contributory factor was the relatively high prices paid for oil and food imports, but in the absence of a complete analysis its effect cannot be quantified.

18. See also Chapter IV.

also help to explain the failure of import volumes to exhibit a normal cyclical contraction (as in the recession of 1966-67), while the diversion of funds to the black market almost certainly contributed to the reduced conversion at banks of foreign currency receipts per tourist.[19]

Table VI-11

ISRAEL'S APPROXIMATE TERMS OF TRADE IMPACTS, QUARTERLY, 1974-75

(1973 I=100)

	1974				1975					
	I	II	III	IV	I	II	III	IV	1974	1975
1. Index of import prices[a]	165.1	177.7	169.6	170.7	187.3	187.9	176.8	172.7	170.8	181.2
2. Index of export prices[a]	122.5	134.3	133.2	134.4	139.0	136.5	134.5	133.9	131.2	136.2
3. Terms of trade index (2÷1)	74.2	75.6	78.5	78.7	74.2	72.6	76.1	77.5	76.8	75.2
4. Percent change from 1973 I	-25.8	-24.4	-21.5	-21.3	-25.8	-27.4	-23.9	-22.5	-23.2	-24.8
5. Oil prices (1973 III=100)	476.4	488.3	401.9	390.0	405.4	411.2	425.8	438.0	439.2	420.1
6. Terms of trade "import effect"[b] as a percent of:										
Domestic resource use	-7.5	-7.0	-6.2	-6.2	-7.5	-7.9	-6.9	-6.5	-6.7	-7.2
GNP	-9.0	-8.5	-7.5	-7.4	-9.0	-9.6	-8.3	-7.9	-8.1	-8.7
7. Terms of trade effect on national income (percent of GNP)[c]	-5.1	-4.8	-4.3	-4.?	-5.1	-5.4	-4.7	-4.5	-4.6	-4.9
8. Percent change in (7) from 1974 to 1975										-0.3

[a] Laspeyres index.

[b] Equals the reduction in imports (relative to 1973 I) required if the fall in the purchasing power of capital imports and of export earnings were equal (i.e. if nominal capital imports changed in proportion to export prices).

[c] Computed as the change in the terms of trade (line 4) times exports, expressed as a percent of GNP (based on 1972 data). This constitutes the approximate effect of the terms of trade changes on real national income (percent change from 1973 I). The figures in lines 7 and 8 show that 4.6 percent must be deducted from the change in constant price GNP from the first quarter of 1973 to 1974, but only 0.3 percent more in 1975 in order to obtain (approximately) the simultaneous changes in Israel's real national income.

4. CAPITAL MARKETS AND CAPITAL FLOWS IN 1975

World capital markets showed an unexpected ability in 1975 to absorb the remaining shocks of the oil price revolution. The process was aided by the extremely rapid increase in imports of OPEC members (see Table VI-8), which reduced the capital flows. The Eurobanking system recovered from the apparent "indigestion" caused by excessive short-term deposits in 1974, and proceeded to accept and disperse a large part of the additional capital flow. One problem remaining (more a substantive economic than a technical financing problem) is the ability of the developing countries to continue

19. See also the discussion in Chapter XV.

financing their greatly enlarged deficits. This, however, remained a potential problem in 1975, and private international banks extended net additional credit to developing countries in an amount exceeding their entire annual capital import (including aid programs) up to 1973.[20] In 1976 (and afterward) such capital flows will probably diminish, but their effect on imports should be mitigated by the anticipated increase in the developing countries' exports.

The year reviewed was also characterized by a shift of capital flows resulting from cyclical differences in various countries; that is, capital tended to move away from the relatively more depressed economies toward those with higher growth rates.

This process was complicated, but not basically altered, by the effects of policy actions upon interest differentials. Thus, for example, late 1974 and early 1975 saw a tendency for capital to shy away from the U.S. (taking the form of reduced inflows in some items, such as stock market investments, and increased outflows in others) Later in the year the U.S. economy rebounded strongly while in most of Europe recovery remained sluggish. Capital began to flow back to the U.S, a tendency strengthened by the countercyclical monetary policy adopted in the second half of the year[21] (see Table VI-12 and Figure VI-2).

5. EXCHANGE RATES AND CAPITAL FLOWS

(a) *International Review*

Even the briefest survey of capital flows must take some account of exchange market developments as well. In summary, it can be said that the floating exchange rates between the major currencies broadly offset the differences in domestic rates of inflation, and thus maintained fairly constant relative price competitiveness in trade over two-year periods (e.g. 1974 and 1975), if not in each year separately. A glance at Table VI-6 shows a much wider dispersion of export price changes in local than in common currency (SDR) terms. Countries with SDR price changes sharply diverging from the average in one year (e.g. Japan) show roughly offsetting variations in the subsequent year. Moreover, extreme

20. According to IMF estimates, bank credit came to over $14 billion in 1975, even exceeding the 1974 figure of nearly $12 billion. By contrast, the 1973 figure was less than $4 billion.

21. This development caused some shift of U.S. credit demand to foreign banks, and so was partly responsible for the unexpectedly weak rise of U.S. bank credit and hence of M. At the same time it tended to raise the exchange rate of the dollar, which, as noted earlier, exerted a directly offsetting monetary effect.

variation from average trends, even in single years (again as in Japan), appears to be correlated with the degree of governmental management of the floating rate. In general, the short-run large discrepancies between prices and exchange rates which occur from time to time under the present system do not seem to last long enough to encourage a drastic reorientation of exports toward particular market areas.[22] Nevertheless, more moderate longer-run trends may well appear, which require attention.

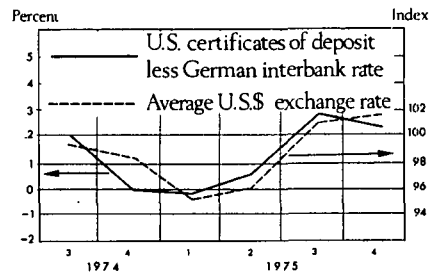
As to capital flows, exchange rate flexibility in the major currencies has meant, for the most part, the avoidance of the massive speculative flows which might well have been induced by the changes in the supply and demand for various currencies associated with the steep cyclical fluctuations of this period. Where significant speculative flows have occurred (e.g. the pressure on the weaker currencies of the EEC "snake"), they have been associated with efforts to prevent flexible movements in rates (i.e. with deviations in the direction of the earlier pegged rate system), or with exceptional political instability (especially the Italian lira).

Admittedly the amplitude of the fluctuations in major exchange rates has been somewhat larger than desirable, and indeed than what might be justified by changes in interest differentials alone (if capital flows were covered in the forward market). It appears that the presence of uncovered flows and, more importantly, of expectational changes concerning differences in domestic inflation (largely justified by widely differing policies) lie behind these excessive swings.

Figure VI-2 and Table VI-12 concisely summarize some of the main relationships. The figure shows the close correlation between the U.S.-German short-term interest differential and average exchange rate of the dollar relative to a basket of currencies (the U.S.$-DM rate is also closely correlated). The U.S. cycle led the European one, so that U.S. interest rates dipped sharply in late 1974 and then stabilized, while European rates came down further in the third quarter of 1975. The dollar followed these movements, falling in late 1974 and rising in the third quarter of 1975. Despite some reversal of international interest rate

Figure VI-2

U.S-GERMAN INTEREST DIFFERENTIAL AND AVERAGE $ EXCHANGE RATE, 1974-75



SOURCE: International Monetary Fund.

22. Of course, short-run opportunities can sometimes be exploited at a relatively low "variable" cost.

differentials, it remained high in the fourth quarter, partly because of purchases by foreign monetary authorities.

Table VI-12 clearly shows the effects of the cycle on trade and capital flows between the U.S. and the rest of the world. Here we see the dramatic strengthening of the current account balance, lagging one or two quarters behind the drop in real GNP. Meanwhile the same factor, combined with monetary policy impacts upon interest rates, produced an offsetting decline in the capital balance (i.e. a larger capital outflow). In the second half of the year the net capital outflow began to lessen (with economic recovery). Due to lags, the current balance does not yet show the effects of the recovery, but this is clearly evident in quarterly and monthly figures since the second quarter.

Table VI-12

U.S. BALANCE OF PAYMENTS — SUMMARY, 1974-75

($ billion)

	1974	1975	
	2nd half	1st half	2nd half
Current balance	-1.60	5.55	6.47
Capital balance[a]	-3.15	-10.38	-4.00
Balance of payments on official settlements	-4.75	-4.82	2.47

[a] Includes errors and omissions.
SOURCE: U.S. Department of Commerce.

(b) *Developments in Israel*

Table VI-13 presents the changes in the average external value of the IL and the dollar during 1975. Cols. 1 and 3 set forth the changes due to the link to the floating dollar, and in cols.2 and 4 the changes due to the devaluations of the IL itself relative to the $ are added.

The dollar strengthened significantly in mid-year (by about 7.5 percent), yet its average value in 1975 hardly differed from that in 1974 (it edged down a little more than 1 percent). Local exchange rate policy played a much larger role in influencing capital and trade flows between Israel and the rest of the world. The year reviewed witnessed a transition from the traditional pegged rate with intermittent large adjustments (the last in November 1974) to the system of creeping devaluation.[23] The introduction of

23. Specific aspects of the impact of the system of creeping devaluation on trade and capital movements are discussed in Chapter IV.

Table VI-13

WEIGHTED AVERAGE CHANGES IN VALUE OF $ AND IL FROM SMITHSONIAN PARITIES (DECEMBER 1971), 1975-76[a]

(percentages)

	IL[b]				
	Weighted by imports[c]		Weighted by exports[c]		
	Due to change in dollar[d]	Total[e]	Due to change in dollar[d]	Total[e]	Dollar[f]
1975					
January	-9.0	-36.3	-11.9	-38.3	-12.0
February	-10.0	-37.0	-12.9	-39.0	-14.7
March	-10.9	-37.6	-13.8	-39.7	-13.1
April	-9.5	-36.7	-12.4	-38.7	-12.5
May	-9.9	-36.9	-12.9	-39.0	-13.0
June	-9.8	-37.5	-12.9	-39.6	-11.9
July	-6.4	-35.8	-9.9	-38.2	-7.2
August	-3.8	-35.1	-7.7	-37.7	-6.8
September	-2.5	-35.9	-6.5	-38.6	-4.3
October	-2.7	-41.6	-6.8	-44.1	-6.7
November	-2.8	-41.9	-6.9	-44.3	-4.9
December	-2.4	-42.2	-6.3	-44.5	-4.9
1976					
January	-2.1	-43.1	-6.5	-45.7	-4.9
February	-1.9	-43.8	-6.8	-46.6	-5.2
March	-0.3	-43.9	-5.9	-47.0	-4.4

[a] These series represent the cumulative changes (since December 1971) in the amount of foreign currency obtainable per IL or per $, rather than the change in the IL price of foreign currency (the conventional concept of the rate of exchange in Israel).
[b] Monthly average position.
[c] 1972 weights.
[d] The change in the IL average value due to fluctuations between the dollar and other currencies. Since June the dollar has tended to strengthen steadily, thus offsetting part of the effect of IL devaluations.
[e] Includes the effect of the official devaluation of the IL.
[f] Reuter's index; change in end-of-month position.

mini-devaluations at a time of payments equilibrium, simply to offset higher internal inflation, may achieve substantially different results from the earlier system, by maintaining trade equilibrium without seriously affecting capital flows. However, pursuance of a policy intended to gradually correct a disequilibrium by devaluing the currency at a rate exceeding (or expected to exceed) the inflation raises the private rate of return (or interest) of foreign relative to domestic assets. Thus the rate of devaluation plus interest on foreign bonds may exceed the expected rate of inflation plus interest on domestic linked securities. This applies even more strongly to expected returns abroad relative to those on unlinked financial assets and many real investments (but not commodity exports and import substitutes). This tends to depress capital imports, stimulate capital exports, and exert related effects on leads and lags in trade. There is little doubt that the mini-devaluations of 1975 did produce effects of this kind, partly

because of the comparatively low rate of domestic inflation which coincided with the introduction of the system. Prices advanced at a 11-12 percent annual rate in the second and third quarters of 1975;[24] in the fourth quarter inflation accelerated, but so too did the rate of devaluation,[25] for a time at least, as well as expectations about the future rate.

Table VI-14

DEVALUATION, INFLATION, AND THE IL–FOREIGN INTEREST DIFFERENTIAL[a]

(percentages)

	d (annual rate of devaluation)			
i_I	18	22	26	40
11	-10.8	-15.1	-19.4	-34.4
25	3.7	-0.5	-4.8	-19.8
30	8.9	4.7	0.4	-14.6
35	14.1	9.9	5.6	-9.4

NOTE: These computations do not cover the entire array of possibilities available to economic units. (For example, Natad gains in excess of inflationary gains are liable to tax; the interest rates in IL are sometimes such as to discourage borrowing for speculative purposes.)

[a] The hypothetical interest differentials shown in the table are computed as follows:

g (IL interest differential) $=[(1+r_I)(1+i_I)-(1+r_F)(1+d)]\times 100$

where: i_I=inflation rate in Israel

r_I=formal interest in Israel (assuming a 4 percent interest rate on IL linked bonds)

r_F=formal interest rate abroad (assuming a Eurodollar deposit rate of 7 percent)

d=rate of devaluation per year (IL/$) — for example, 18 percent=12 devaluations of 1.4 percent; 26 percent=12 devaluations of 2 percent; etc.

g=interest differential (in IL)

Table VI-14 presents some illustrative calculations of IL interest differentials, on simplified assumptions corresponding to several hypothetical expected rates of devaluation and local inflation. We cannot of course know the expectations, but col. 1, calculated for a 11 percent local inflation rate, closely corresponds to the situation in the early period. It shows that at this rate even a 22 percent devaluation would cause the return on an ordinary Eurodollar deposit to exceed that on an investment in a typical local asset (fully linked government bonds) by 15 percent. It should be borne in mind, of course, that the feasibility calculations of firms, the principal operators in the foreign exchange

24. Had it not been for the introduction of mini-devaluations in mid-1975, similar or even larger speculative flows would certainly have been stimulated if sizable overall deficits and reserve losses had reappeared and there had been a repetition of the earlier pattern of delayed devaluation.

25. Another 10 percent adjustment at the end of September.

market, include not only the returns to alternative investments in assets, but also the price of credit, and this rose steeply in 1975.

Because an improvement in Israel's price competitiveness merely requires a devaluation at a rate more than offsetting the extra production costs (excluding indirect tax increases), it is possible for mini-devaluations well below the local inflation rate to produce a real improvement and yet maintain a positive interest differential on IL assets.[26] However, the actual effect on speculative movements (in both the capital and current account) depends upon expectations, and in a period of balance of payments alarm these may tend to exaggerate the probable rate of devaluation.[27]

Statistical tests suggest that the effect of devaluation expectations accounted for much of the reduction in private capital inflows (personal remittances, business loans, and direct investment) in both 1974 and 1975.[28] This is in addition to the stimulus provided to capital outflows, legitimate or not, by Israeli residents and firms, shifts of leads and lags in trade, and the diversion of tourist revenues to the black market. All estimates are tentative, but probably large sums are involved. It appears from related calculations that the net effect of these and other factors upon foreign currency reserves has been largely offset since late 1975 by governmental borrowing and credit received by others with government support.[29]

To sum up, the two main policy instruments employed since 1973 (and especially in 1975) to cope with the exacerbation of Israel's balance of payments problem due to oil prices and the defense burden are (a) a slowdown in real demand and GNP growth, and (b) currency devaluation.

Devaluations (whether sudden or gradual) tend to improve the current balance rather slowly, but the negative impact of a creeping devaluation upon the capital balance, although not cumulative, is immediate. Moreover, in 1975 the positive effect on the

26. For example, if in 1976 foreign export prices go up 6 percent in dollar terms (12 percent in 1975), while the Israeli price level rises 21 percent net of indirect tax effects (30 percent including these effects), then constant competitiveness requires a total devaluation of only 15 percent. Thus, in Table VI-14 the 18 percent devaluation allows a small (3 percent) real change, while leaving a sizable positive interest differential in favor of an IL investment. By contrast, a 26 percent devaluation leaves none, while a 40 percent devaluation drastically shifts the incentives the other way.

27. The change from full to 90 percent linkage of IL bonds and the increased tax on trade in these assets (in 1976) tend to reduce the leeway of devaluation; that is, they tend to lower the relative returns to IL assets for any given rate of devaluation.

28. These capital transfers fell from $731 million in 1973 to $500 million in 1974 and $392 million in 1975 (see Chapter V). The approach used in such experimental estimations is partly described in "Forecasting Capital Flows--Some Econometric First Steps", Bank of Israel, *Economic Review*, No. 43, June 1976.

29. Unfortunately, no data were available on the latter point at the time of writing this chapter.

current deficit was blunted and delayed by the recession abroad,[30] Since August 1975 renewed growth abroad has permitted a strong export recovery (in goods and services), while imports have been stable or even falling. Continuation of this trend should help to gradually overcome the speculative effects as well, barring rigid adherence to any preannounced rate of devaluation. In the meanwhile, however, financing the enlarged overall deficit remains the crucial and problematic requirement.

30. Israel's performance was more impressive than may appear at first glance. Its market trend growth rate in 1966-74 came to over 9 percent. The actual 2 percent rise in commodity exports (3.3 percent in goods and services) represents a 5 percent rise in the market share.