

## CHAPTER I

### MAIN ECONOMIC DEVELOPMENTS

The year 1978 saw a change in the economic scene. There was a resumption of growth, although on a modest scale compared with earlier periods, nondwelling investment resumed its uptrend, the slump in dwelling investment bottomed out, and private consumption accelerated strongly. These developments were accompanied by a sharp escalation of inflation and a renewed widening of the balance of payments deficit on current account. The civilian current deficit rose by some \$ 300 million, after it had improved by a similar sum in each of the two preceding years; this was the net outcome of a more sluggish export advance and an accelerated expansion of imports. Inflation worsened appreciably, shooting up from a 35–40 percent annual rate until September to 70 percent or more in the last three months of the year. Most of the upward thrust was generated by the growth of domestic demands, which led to an approximately 6 percent increase in domestic resource use, reversing the 2–3 percent downtrend in the two preceding years.

The more buoyant domestic demand was therefore the dominant factor in bringing the economy back onto a growth path. The prolonged stagnation of GNP and the attendant policy of devaluations have not produced the conditions for a predominantly export-led growth.

After the world oil crisis and the steep jump in defense spending in the wake of the Yom Kippur War, economic policy-makers were confronted with the urgent need to pare the current deficit to manageable proportions. The long-term solution is obviously a change in the composition of resource uses in favor of exports. In the short run domestic demands had to be frozen and even reduced in order to dampen economic activity and thereby check the growth of imports. In addition, the cooling of domestic demands was a precondition for altering relative prices to the extent required for a structural change in production and uses. The data show that since 1975 the export share of total uses has moved up, in itself a welcome development, but at the same time capital formation shrank while the weight of total consumption remained static. What is more, the restraining of economic activity did not include public civilian services. On the contrary, public civilian consumption continued upward at the pace evident since the beginning of the decade, with the sector's workforce expanding greatly. The overwhelming share of the additional employed in 1975–77 were absorbed by the public services sector, while employment in the business sector held steady. In contrast to the economic retrenchment of 1967, in the present period of restraint there was no significant growth of unemploy-

TABLE I-1  
 MAIN ECONOMIC INDICATORS, 1975-78<sup>a</sup>  
 (percent annual increase)

	Average					1975	1976	1977	1978
	1961-65	1966-67	1968-70	1971-72	1973-74				
<b>Resources and uses (in constant prices)</b>									
Total domestic uses	10.5	1.4	14.5	7.8	8.9	4.5	-4.5	-4.0	8.2
Gross domestic product <sup>b</sup>	10.0	2.0	12.5	11.5	4.8	3.9	1.2	0.5	4.8
Gross domestic product - business sector (excl. residential rents) <sup>c</sup>									
Total	10.9	-0.1	14.5	13.1	3.1	3.6	0.2	-0.8	5.1
Per employed	6.1	3.7	8.6	6.6	2.0	4.0	-0.4	-2.8	1.5
Real disposable private income <sup>d</sup>	10.6	3.5	8.7	13.5	6.9	-0.7	-6.8	7.3	6.0
Private consumption									
Total	10.3	2.3	8.4	7.8	7.9	0.6	3.9	4.3	8.0
Per capita	6.1	-0.6	5.2	4.4	5.5	-1.7	1.6	2.0	5.7
Public consumption									
Total	10.6	21.4	17.1	-0.3	22.3	10.0	-9.1	-13.0	11.3
Domestic <sup>e</sup>	9.2	16.3	13.9	5.7	16.5	-0.8	-3.1	-1.0	1.7
Thereof: Civilian consumption		5.4	5.3	13.4	5.5	4.6	5.5	3.3	4.6
Total domestic uses, incl. direct defense imports	10.2	-1.0	13.7	9.8	7.7	1.5	-2.5	-0.3	5.8
Weight in GNP (percent, in current prices)									
Public sector income <sup>f</sup> less subsidies						38.0	45.7	43.8	44.6
Liquidity absorption <sup>g</sup>						19.7	24.4	21.5	22.4
Subsidization of credit						8.6	9.1	9.7	11.0
Public sector demand surplus <sup>h</sup>						17.4	9.5	10.9	9.0
Gross domestic investment (in constant prices)	11.3	-19.1	28.5	17.2	1.0	5.4	-13.7	-9.9	4.3
Balance of payments, <sup>i</sup> excl. trade with administered areas (in dollars)									
Imports	12.0	7.2	22.0	11.5	51.3	11.5	-1.3	6.3	22.8
Exports	15.6	11.4	13.5	24.4	34.1	1.9	18.8	24.7	20.5
Import surplus (\$ million)						4,112	3,337	2,762	3,513
Foreign currency debt (\$ million)						7,617	9,371	10,715	12,184
Foreign exchange reserves <sup>j</sup> (\$ million)						1,040	1,156	1,359	2,242

<b>Population and employment</b>									
Average population	3.9	3.0	2.9	3.1	2.3	2.3	2.3	2.3	2.2
Number of Israeli employed	4.8	-2.5	4.8	4.2	2.1	1.5	1.3	2.9	4.6
Unemployment rate (as a percent of civilian labor force), absolute figures	3.6	8.9	4.8	3.1	2.8	3.1	3.6	3.9	3.6
<b>Prices and national income (nominal)</b>									
Average monthly earnings per employee post <sup>k</sup>	13.6	9.4	6.1	15.0	31.7	36.5	32.9	47.2	54.0
Implicit price deflator for GNP	8.0	4.8	4.4	13.5	27.8	37.4	27.0	43.1	52.7
Import prices <sup>l</sup>	9.7	2.1	7.7	18.3	29.5	41.7	32.9	41.3	74.0
Consumer price index (annual average)	7.4	4.8	3.6	12.4	29.5	39.3	31.3	34.6	50.6
National income	18.8	6.5	17.0	27.1	32.5	39.4	24.4	44.6	61.1
<b>Finance (annual averages)</b>									
Money base <sup>m</sup>	18.9	13.6	11.6	40.9	14.3	27.8	11.8	50.9	30.3
Money supply	17.6	13.6	10.2	26.2	22.5	31.0	14.3	44.2	37.6
Other liquid assets of the public	32.5	23.7	26.5	28.7	22.4	48.6	65.9	62.7	106.5
Bank credit to the public <sup>n</sup>	19.6	20.9	16.0	20.7	37.2	53.0	34.0	52.0	97.0

- a Until 1968 the percentage changes were calculated on the basis of the previous year's prices. From 1969 to 1975 the rates of real change were calculated on the basis of 1970 prices, and since 1976 they have been calculated on the basis of 1975 prices.
- b Valued at the effective rate of exchange.
- c Defined as the total product, less public sector and nonprofit institution services.
- d Gross disposable private income from domestic sources, before deducting compulsory loans.
- e Public consumption, less direct defense imports.
- f Revenue from taxes, compulsory loans, and property and entrepreneurial income; subsidies do not include the imputed subsidy element in credit.
- g Public sector revenue, less net transfer payments.
- h As defined in the national accounts.
- i Goods and services (imports c.i.f., commodity exports f.o.b., and service exports valued on the basis of c.i.f. recording of commodity imports - in dollars).
- j Net foreign currency balances in the Bank of Israel at the end of the year.
- k Israeli employee posts, including part-time and supplemental work. Since 1969 a new series based on National Insurance Institute data, which include inter alia East Jerusalem.
- l Changes in foreign prices and in the effective exchange rate of the Israeli pound.
- m Currency in circulation with the public, plus total liquid assets of the banking institutions.
- n Until 1970 includes bill brokerage credit.

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

ment (although there may have been an increase in disguised unemployment), the labor force participation rate sagged, while the labor market remained tight, with virtually full employment.

In the business sector the economic slowdown did not affect all branches in equal measure. Residential construction was cut back appreciably, with the number of building workers dropping steeply, while employment in the services rose. The labor input was fairly stable in industry, transportation and communications, and agriculture. The slump in residential construction was a major factor in the slowing of the economy. This followed an unprecedented boom in the early 1970s, and by and large reflected the cyclical pattern characteristic of the construction industry. The downswing was aggravated by the sharp reduction of public sector building in order to cool the economy and by the sagging of the population growth rate from 3.5 to 2 percent per annum.

The numerous devaluations implemented in 1974–77 (from November 1974 to the eve of the foreign currency reform in October 1977 the external value of the Israeli pound was slashed 2.5-fold), which were intended to alter relative prices, together with the stiffening of taxes with a view to reducing the public's disposable income, the mounting pressure for wage increases, and the heavier volume of transfer payments designed to prevent the erosion of real income – all these caused prices to shoot up at an approximately 35 percent annual rate despite the weak tone of the economy. An accommodating monetary policy was followed throughout most of the period, permitting the extra costs to be passed on to prices while avoiding the creation of overt unemployment.

In 1977 the government eased its fiscal absorptive policy, with the result that the share of net taxes in GNP declined. The public's real disposable income grew, in fact, by about 5 percent last year in spite of the almost total stagnation of GNP. At the same time there was a sizable monetary expansion, reflected by a huge increase in the public's financial asset holdings. In addition to, and to some extent because of, these factors, in the latter part of 1977 there were signs of a turnabout in the housing market, signalling the start of a recovery of the construction industry: sales from the existing stock of dwellings rose, home prices raced ahead of all other items in the consumer price index, and the volume of starts rebounded. As with the industry's downswing, so its emergence from the slump was due to internal factors characteristic of the industry, as well as to external forces which hastened the process. With the drop in housing completions, a gap was created between the supply and demand for finished units; because it takes a long time to put up homes, this caused prices to spiral sharply upward. Additional thrust on dwelling prices was generated by the foreign currency reform: this immediately greatly appreciated the public's foreign currency asset holdings, which combined with the large amount of liquidity it already possessed in the wake of the monetary expansion of 1977. In the year reviewed the number of new home starts was greatly stepped up, but because of the un-

avoidable drop in completions, dwelling investment stabilized after two years of steady contraction.

Nondwelling investment also rose precipitously this year, with the growth permeating nearly all industries. The upturn occurred in the early stage of the economy's recovery and was one of the underlying factors in the expansion of GNP. This can apparently be attributed to the expectation of a substantial growth of demands once peace is established with Egypt, to the cumulative influence of the subsidized credit, which accounts for a large part of total investment finance, and to the increase in its subsidy element with the sharpening of inflation.

Besides these factors, in 1978 the public sector's moderating influence on domestic demands weakened. After declining two years, public domestic consumption and capital spending stabilized and even turned up fractionally in 1978. In addition, the share of taxes in the total product fell, in line with the previous year's trend, thus further stimulating private consumption.

An estimation of the public sector's demand surplus (which this year includes for the first time the subsidy element in credit provided to the business sector) shows that it continued to rise, although much more slowly than in 1977. The effect of the demand surplus, however, must be gauged in the light of its large size relative to the product and against the backdrop of recent developments in the economy. Because of the cyclical upswing in the private sector's domestic demands, the public sector demand surplus has a distinct potential inflationary influence.

One of the major factors in the renewed growth of demands was the large-scale monetary expansion. In 1977 there was a comparatively big increase in both short-term credit and that for medium and long periods. The public used part of these funds to enlarge its financial asset holdings in the expectation that the return on such assets (notably shares) would exceed that on physical assets (housing, etc.). But the public's expectations underwent a drastic change with the foreign currency reform, which unified the exchange rates for capital transactions and exports and raised the official exchange rate by nearly 45 percent. This influenced the yield expectations, enhancing the profitability of investments in physical assets, and appreciated the public's foreign currency assets. Monetary policy and the growth of credit were unable to counteract the stimulative effect of the 1977 monetary expansion and the foreign currency reform. This induced the public to reshuffle its assets portfolio, with the weight of physical assets rising. The growth of short- and long-term credit in 1978 was not faster, in real terms, than in the previous year, but, as stated, it was too strong to slow the increase in demands and prices.

The reform transformed the monetary scene: by making the economy more open to the international money market with the floating of the Israeli pound, the array of assets

and liabilities with monetary significance was enlarged. Now, with the existence of an elastic supply of foreign currency assets and liabilities, the magnitude of the monetary expansion is largely determined by the public's financial demands. Although monetary policy can now influence the dimensions of the expansion in the Israeli currency segment to a greater degree than before, the relationship between developments here and the movement of the exchange rate has grown closer. Indeed, a restrictive monetary policy in this segment in the second half of the year led to a large capital import, thereby preventing the exchange rate from adjusting to the rate of inflation and precluding an improvement in export profitability. In other words, in the absence of fiscal restraint and with the virtually total scrapping of foreign exchange controls, it will be hard to conduct a policy of monetary restraint without detrimentally affecting the exchange rate.

The hiking of the price of foreign credit by the Bank of Israel at the end of 1978 has given monetary policy a little more latitude, but not enough to diminish the need for a constrictive fiscal policy that will harness domestic demands and ensure an adequate level of export profitability.

The increase in demands was also reflected in employment. For the first time in three years the business sector labor force expanded appreciably without any slowing of the growth of public service personnel. Despite the stagnation of the national product in previous years, the labor market was marked, as stated, by almost full employment, thanks to the absorption of workers in the public sector. With the renewed growth of employment in the business sector, unemployment declined and the labor force participation rate rose, with a consequent tightening of the labor market. The fact that in the business sector the demand for both labor and capital assets rose immediately with the growth of domestic demands suggests that the amount of idle capacity created previously was insufficient to enable the sector to respond, at least in the short run, to the more buoyant level of domestic demands, in contrast to what past experience would have led one to expect. The data on imports strengthen this assumption: despite the rise in their relative price, imports expanded greatly – even more than required for current production.

The upturn in demands and the response of the labor market go some way to explain the sharp escalation of inflation during 1978. Since inflation – mostly of the cost-push variety – had been running at an approximately 35 percent annual rate ever since 1974, the public expected it to continue unabated. This expectation was strengthened by the various indexation devices, institutional and informal alike, which caused prices and wages to continue spiraling upward and altered the exchange rate. The foreign currency reform, which made imports much dearer, and the wage policy in force at the beginning of 1978, which in the private sector led to the signing of wage agreements that took into account a predicted further steep rise in prices, added fuel to the inflationary fires.

At the same time the unrealistic wage policy in the public sector touched off an unending bout of labor disputes, with negotiations with the various groups of workers dragging. The result was a long delay in signing the wage agreements, sharp fluctuations in real wages, and pressure for further pay adjustments, which did not find full expression in 1978.

This had a destabilizing effect on prices. Even though the impact of external factors is relatively small, it can greatly alter the rate of inflation. It is in this light that the influence of the rise in dwelling prices, evident since the second half of 1977, and that in domestic demands on the rate of inflation should be viewed. The growth of demands, which on the face of it did not greatly exceed the economy's production capacity, sharply accelerated the advance of prices.

The balance of payments developments should be gauged in the light of the foreign currency reform and the upturn in domestic demands. One of the main purposes of the reform was to induce a larger supply of foreign currency, thereby loosening the balance of payments constraint on the renewal of growth. In 1978 this object was achieved. First of all, the increased inflow of private sector capital, which improved the way the import surplus was financed, was to some extent a product of the reform, notably the 45 percent jump in the exchange rate on capital transactions and the liberalization of capital movements. Secondly, the percent of export value added rose, which means that the deceleration was less pronounced in net than in gross exports. The steep rise in the relative price of imports caused by the reform encouraged the production of import substitutes, a development masked by the sharply higher volume of imports due to the renewal of economic growth and the concomitant buildup of inventories. The net contribution of this development to the balance of payments is not clear, for the maintenance of a higher effective exchange rate for imports than for exports results in a distorted resource allocation. Finally, the reform also influenced the rate of inflation, both because of its stimulative effect on demands and by making imports dearer.

These influences were not offset by the adoption of adequate measures to curb domestic demands, and the aggravation of inflation in itself impeded the adjustment of the exchange rate to the rise in domestic prices, thus hurting exports. The adverse balance on goods and services, excluding direct defense imports, increased by some \$ 300 million – the net outcome of a more sluggish export advance and a faster growth of imports. In nondiamond commodity exports the uptrend faltered, although various indicators of export profitability point to a further gain, albeit a small one, or at least a stable rate of profits. However, it may well be that this development created the impression among exporters that the improvement in profitability in recent years was not a permanent feature and that the trend was likely to be reversed with a change in economic conditions.

It is a reasonable assumption that the slowing of exports was due to domestic developments, since world commerce continued to expand at about the same rate as in the previous year (5–6 percent) and in view of the small size of the Israeli economy compared with the world markets. The growth of domestic demands was, to be sure, quite modest, and on the face of it one could expect that a mild upturn, after a protracted stagnation, would not in the initial stages constrain the continued vigorous growth of exports. However, the fact that the rise in investment and employment occurred in most branches of the private sector, coupled with the much larger volume of imports this year, indicates the absence of any significant amount of excess capacity, at least in the short run. There were two other factors that may have caused the export advance to drag: (a) Some of the overseas sales in recent years were made by producers geared primarily to the home market, and with the brightening of the local business picture, they abandoned the foreign markets. It is a reasonable inference that the reform and its attendant uncertainties diminished the enthusiasm of such producers for stepping up their foreign sales. (b) With the unification of exchange rates under the reform, part of the goods which previously could be sold abroad thanks to the heavy support they received in the form of incentives, now had to compete with goods that were more profitable to the economy. Producers who included the incentives in their export profitability calculations cut down their overseas sales after the reform. No direct information is available on the extent of this phenomenon, but the increase in export value added supports the assumption that this did in fact occur. Such exports were of course unprofitable to the economy from the start, and their elimination will probably result in a better resource allocation in general and the bolstering of the balance of payments in particular.

After the reform the effective export exchange rate for invisibles went up faster than for commodities; this provides a potential for the export of knowhow, etc., which until now has been tapped to only a small degree. Despite the more sluggish gain in exports in the year reviewed, the share of this final demand in the product did not shrink, and it remained far higher than in 1975. The rising export share of GNP was achieved at the expense of the stagnation of GNP for three years and without being accompanied by a drop in the share of consumption. This casts some doubt as to whether there has been an enduring structural change in the economy; at any rate it will not be easy to preserve this achievement in the future, especially considering the change that has taken place in the structure of employment in recent years and the expected much heavier domestic defense spending.

In the course of 1978 it became clear that the desired renewal of growth was materializing but at the expense of some setback in the balance of payments current account, and even more worrisome, an exacerbation of inflation. The harmful impact of the steep rise of prices is especially acute in certain spheres. First of all, the various inflation-

proofing devices are not perfect; there are sharp monthly swings in real wages, pension payments, etc., and this tends to increase social unrest. Secondly, with inflation running at such a high rate, unplanned and unfunctional price differentials arise between various goods and services, and linkage to the average cost-of-living index cannot prevent either the erosion of income or overcompensation in different groups. Thirdly, there was a diminished incentive in 1978 to improve production, for the boosting of profits by increasing productivity is a slow, gradual process, whereas there were good prospects for turning a quick, tidy profit on capital transactions. Finally, with the present pace of inflation it is hard to ensure a sufficiently rapid adjustment of the exchange rate that will prevent a deterioration in the balance of payments.

To sum up, in view of the high rate inflation has reached in the last few months, its cooling has become the paramount economic policy goal in the short run. There is no magic formula that will ensure immediate and certain success, but a number of measures can be singled out whose resolute, uncompromising implementation is essential for toning down inflation and the public's expectations regarding the future rate of price advance. To heighten the chances of success there must be a concerted effort on both the demand and costs sides.

The public's expectations have played an important role in the inflationary process. To diminish its influence in determining wages, the wage indexation arrangements must be modified, with the present rate of indexation being raised. This should eliminate, or reduce, the need to take account of the predicted future rate of inflation in renegotiating labor agreements, thereby deemphasizing the role played by expectations in wage determination.

In view of the weight of demand factors in exacerbating inflation, direct action must be taken in this sphere too in order to eventually weaken the inflationary spiral and bring it down to a level that will cause a minimum of harm. First of all, public sector activity must be curtailed and even frozen, especially considering the expected steep jump in defense spending with the redeployment of Israel's armed forces in the Negev. In recent years there has been a marked structural change in employment, with the public services sector absorbing most of the additional manpower. Since the government's ability to siphon off more money through taxes is limited because of the various indexation and compensatory devices, and since a diminished dependence on external sources of finance has become a prime national target, there is no escaping the need to reduce the share of public services in total resource use. In other words, the freezing, and perhaps even absolute decrease, of public sector employment is necessary for relieving pressure in the labor market and making more resources available to the business sector.

Secondly, there must be a more rational use of the business sector's resources. The far-reaching modification of the policy of protecting domestic production and of the terms of directed credit granted for long, medium, and short periods should go some way to bring this about. A not insignificant portion of domestic production is sheltered by high tariff barriers, and its maintenance at the present rate depends on the degree of protection which the high customs duties afford. Under the full and perhaps even over-employment conditions expected in the coming years, the lowering of the protective barriers would lead to a more efficient resource use with respect to part of domestic production, thereby helping to ease pressure on prices and strengthen the balance of payments. This would, in effect, complement the October 1977 reform, bringing the effective exchange rate for imports more into line with those for exports and capital transactions. Needless to say, a precondition for the success of this measure is an adequate mobility of the productive factors.

As for credit, in both that granted for medium and long terms through the financial institutions almost entirely in accordance with government directives and that supplied by the Bank of Israel through the export funds, there is an element of subsidization whose magnitude increases with the rate of inflation. The low interest charged on long-term credit distorts the price of capital and spurs overinvestment because of the widening differential between the benefit of an investment to the national economy and that to the individual entrepreneur. This stimulation of capital expenditures expands domestic demands, heightens the pressure on prices, and aggravates the balance of payments problem. In addition, the very existence of nonindexed liabilities makes prices more unstable. Inflation appreciates the real wealth of those borrowing on nonindexed terms, thus further heating demand and prices. The upping of the interest rate — by indexation to the price level — is a precondition for achieving a more efficient use of capital and for weakening pressure on prices.

The rapid growth of the directed export funds increased the support accorded exports — a desirable object in itself — but at the expense of a large-scale monetary expansion, which had a harmful effect on prices and the balance of payments. What is more, the growth of these funds narrowed the scope within which monetary policy can operate effectually, and this precisely at a time when the floating of the Israeli pound required that monetary policy be endowed with greater maneuverability.

In view of the aforesaid, it would be desirable to restore to credit and the interest rate their basic economic functions and to terminate their role as an instrument for subsidizing economic activity.

Despite the unfavorable turn for the worse which inflation and the balance of payments took in 1978, the price advance can be toned down and exports greatly stepped up along

with the continuation of economic growth, provided that the share of consumption in resource use is reduced. This can be achieved by maintaining a high level of private sector saving, freezing and even damping public civilian consumption in general and the absorption of manpower in the public services in particular, and arresting the overstimulation of investment through the subsidization of capital.