

CHAPTER II

RESOURCES, USES, AND INCOME

1. MAIN DEVELOPMENTS

The year reviewed saw a change of trend in domestic demands. After being held down in 1975–77, the level rose 6 percent this year. Private consumption expanded by 8 percent, after moving up at an average annual rate of less than 4 percent in the previous period, while a 9 percent growth of business sector investment ended a two-year downturn. In production, the change of trend was confined mainly to the construction industry, which began to bounce back after losing considerable ground for two years; the rest of the economy made only slight headway. These developments were also reflected in the balance of payments: the deficit widened in 1978 due to a more sluggish growth of exports and an acceleration of imports after they had contracted noticeably in 1976–77 due to the leashing of domestic demands. In the labor market the changes were reflected by a rise in the participation rate and a decline in unemployment. The additional employed were absorbed by the business sector (where the number of workers was up 4 percent) and by the public sector (up 9 percent).

Signs of a change were already visible at the end of 1977. The causes can be traced to past developments in the economy and recent exogenous factors. The major developments in previous years were the sagging of construction activity on the one hand and the impressive gain in exports and exports profitability on the other. Toward the end of 1977 residential construction began to pull out of its slump, thanks mainly to long-term cyclical factors characteristic of this industry. The recovery was mirrored on the demand side by a lively sale of homes in the early stages of construction and a decline in the supply of unsold finished units in the second half of 1977; on the supply side, there was an increase in the number of private building starts (up 13 percent in the second half of 1977 compared to the first half). With regard to exports, sales of goods climbed in the two preceding years (at an average annual 17 percent rate), bringing up their share in the business sector product from 27 percent at the beginning of the 1970s to 36 percent in 1977 and thus increasing their influence on the economy. The expectation that exports and their weight in the product would continue to rise in 1978 stimulated investments in export industries.

To these developments must be added external factors which accentuated the change of trend. In the latter part of 1977 a foreign currency reform was introduced which included *inter alia* a large devaluation for all foreign currency transactions (45 percent in

TABLE

RESOURCES AND
 (IL million,

	1975	1976	1977	1978
Resources				
1. Gross national product	75,368	96,797	140,115	223,855
2. Imports ^b	56,876	73,597	101,513	194,438
3. Imports, excl. direct defense imports	43,917	59,240	88,251	163,938
4. Import surplus (2-15)	29,855	33,139	34,184	75,260
5. Total resources for domestic use (1+4)	105,223	129,936	174,299	299,115
6. Total resources (1+2)	132,244	170,394	241,628	418,293
Uses				
7. Private consumption	46,408	62,078	88,110	146,696
8. Public consumption	33,935	40,936	51,907	91,371
9. Public consumption, excl. direct defense imports	20,976	26,579	38,645	60,871
10. Public civilian consumption	8,041	11,119	17,435	27,886
11. Gross domestic investment	24,880	26,922	34,282	61,048
12. Investment in dwellings	8,728	9,306	9,855	16,866
13. Total domestic uses (7+8+11)	105,223	129,936	174,299	299,115
14. Total domestic uses, excl. defense imports (7+9+11)	92,264	115,579	161,037	268,615
15. Exports ^c	27,021	40,458	67,329	119,178
16. Total uses, excl. defense imports (14+15)	119,285	156,037	228,366	387,793
17. Total uses (13+15)	132,244	170,394	241,628	418,293
18. Net factor payments abroad	2,753	3,494	3,780	7,299
19. Gross domestic product (1+18)	78,121	100,291	143,895	231,154
20. Ownership of dwellings	8,385	10,720	13,482	22,233
21. Public and nonprofit institution services	12,724	16,705	27,207	43,641
22. Gross domestic product at market prices (19-20-21)	57,012	72,866	103,206	165,280

^a Calculated at constant 1970 prices for 1969-72. From 1976 it is calculated at constant 1975 prices.

^b Valued at c.i.f. prices and at the effective rate of exchange. Includes imports from the administered areas; excludes interest paid by the public sector.

SOURCE: Central Bureau of Statistics.

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USES, 1975-78
 at current prices)

Average 1969-72	Percent annual increase					
	Quantity ^a			Price		
	1976	1977	1978	1976	1977	1978
10.9	1.2	1.2	4.7	27.0	43.1	52.7
11.7	-2.6	-2.4	10.1	32.9	41.3	74.0
11.3	2.2	5.5	5.8	32.0	41.2	75.5
8.0	-18.8	-20.5	22.2	36.6	29.7	80.1
10.5	-4.5	-4.0	8.2	29.3	39.8	58.6
11.2	-0.5	-0.3	6.9	29.5	42.2	62.0
7.2	3.9	4.3	8.0	28.8	36.1	54.2
10.0	-9.1	-13.0	11.3	32.7	45.7	58.2
8.8	-3.1	-1.0	1.7	30.7	46.9	54.9
5.7	5.5	3.3	4.6	31.1	51.9	52.9
18.4	-13.7	-9.9	4.3	25.4	41.3	70.7
33.7	-12.5	-21.0	-1.7	21.8	34.0	74.0
10.5	-4.5	-4.0	8.2	29.3	39.8	58.6
10.2	-2.5	-0.3	5.8	28.4	39.8	57.7
14.0	15.2	11.7	3.3	30.0	48.9	71.3
11.1	1.5	2.8	5.1	28.8	42.4	61.6
11.2	-0.5	-0.3	6.9	29.5	42.2	62.0
11.4	3.2	-18.9	10.5	22.9	33.4	74.7
10.0	1.2	0.5	4.8	26.8	42.8	53.2
8.4	8.7	6.0	4.5	17.6	18.7	57.8
6.2	1.1	2.1	3.7	29.9	59.5	54.6
12.3	0.2	-0.8	5.1	27.6	42.8	52.3

^c Valued at f.o.b. prices and at the effective rate of exchange. Includes exports to the administered areas; excludes interest received by the public sector.

the case of capital transactions). The devaluation, which was unexpected, increased at a stroke the wealth of private individuals by appreciating their financial assets in foreign currency. This inevitably found expression in the growth of household demand, and hence in a more buoyant private consumption and purchase of homes. Political developments generated expectations at the beginning of the year surveyed of a stronger domestic demand in the future, whether because of the redeployment of the Israeli army in the Negev or because of a heavier capital import.

The government too was responsible for the change in domestic demands. A policy of restraint depressed public consumption (excluding direct defense imports) by 4 percent in the two preceding years, but in 1978 the level turned up 2 percent and direct government investments, excluding construction, also rose. The increase in government activity was reflected in domestic demands, and to an even greater extent in the labor input.¹ The government contributed to the expansion of demands in the private sector by intervening in the capital market through the subsidization of credit. The sector's unlinked liabilities to the government mounted steadily over the years, and with the escalation of inflation their subsidy element swelled appreciably in the last few years (in 1978 the subsidy element rose 13 percent in real terms to reach IL 25 billion).² This had a distorting effect on the allocation of the economy's resources and evidently also had implications for the distribution of incomes; what is more, it helped augment the wealth of the private sector and thus stimulated its domestic demands.

The turnabout in the economy's development and the resulting expectations heralded, in early 1978, an intensification of growth throughout the year, primarily in response to the domestic demands, and sustained export advance at a rate eclipsing the national average. If there had been spare productive capacity in the economy at the beginning of the year, the rising domestic demand could have been met without slowing down overseas sales. But apart from the construction industry, there was apparently no excess capacity in the business sector that could be activated in the short run.³ The business

¹ Labor input in the public sector grew by 10 percent according to labor force surveys (which are considered a very reliable source), but National Insurance Institute data, which are used to estimate public consumption for the national accounts, indicate a rise of only 4 percent. For a detailed discussion see the chapter on "Wages and Employment".

² This estimate, made this year for the first time by the Central Bureau of Statistics, measures the differential between the interest paid by the private sector to the government and that which would have been paid if credit had been given at the market rate. This estimate is downward-biased since it does not include the subsidy component of credit provided to households.

³ See the detailed discussion in Section 2 below.

sector exclusive of construction forged ahead even when domestic demands were slack, and all signs point to a change in its production mix in the direction of exports.⁴ In 1978 the sector could not step up production to meet the heavier demand without reducing exports, even if there had been unutilized capital stock which in the past had been used for production for the domestic market; consequently, the incremental domestic demand caused exports to decelerate.

The growth of exports during the year was influenced to some degree by the foreign exchange reform of October 1977, which also had a significant impact on production. The liberalization of foreign currency control and unification of exchange rates were intended to help make the economy more efficient by doing away with the distorting system of export incentives and thus getting rid of unprofitable exports (from the standpoint of the economy). An input-output analysis shows that such sales did in fact decrease in 1978. Exchange rates were not completely unified, because substitutes for imported goods were not exposed to foreign competition; it is now more profitable to produce such goods than those for the foreign market, and there are indications of a growth in production of import substitutes (notably for industry).

These interrelated factors would not in themselves have led to a rise in the export production profitability index, after it had gone up steeply in the two preceding years (the index of export commodity prices relative to the prices of nontradables rose 16 percent in these two years). The large subsidy element in the cheap credit granted to exporters in 1978 helped to enhance the profitability of their production.⁵ The change in the real exchange rate trend may contribute to a better production mix, but this gain is liable to be erased. It should be noted that a reversal of the structural change in the economy within the short space of a few years usually has two negative effects: first, a loss of product during the adjustment period; and secondly, investments inconsistent with the change in the product mix. At the same time, there was an improvement in Israel's balance of payments during the transitional period.

The balance of payment deficit on current account, excluding direct defense imports, was \$ 300 million higher than in 1977. This was the outcome of a more laggard expansion of nondiamond exports (6.5 percent as opposed to 13–14 percent in each of the previous two years) and a heftier civilian import (approximately 10 percent, not counting diamonds). Imports were greater than required for current production, as manufacturers built up stocks at the expense of foreign currency. In addition, part of the growth of the deficit –

⁴ See the chapters on Industry and Agriculture in this Report.

⁵ According to estimates of the subsidy content of such credit, their profitability even increased during the year. However, since this gain was unexpected, it had a smaller impact on export production than an expected rise in profitability would have had.

that stemming from the world price rise — was not significant from the aspect of its implications for the future.

The high domestic inflation, one of the principal features of the past few years, continued in 1978. At the beginning of the year the price rise sharpened because of the dearer cost of imports after the large devaluation in October 1977; toward the end of the year the level accelerated further because of demand pressures, originating chiefly in construction and related industries.

Inflation, which since 1974 has been mainly of the cost-push variety, could have persisted indefinitely without being bridled to any noticeable extent, for two reasons: (a) The public's liquidity was not affected during the entire period because of the money pumped into the economy by the public sector. (b) The high inflation does not hurt the individuals' net wealth; on the contrary, since the private sector's unlinked debt to the government is much larger than its total money holdings (more than IL 100 billion vs. IL 22 billion), the rise in prices augments the wealth and fuels, rather than cools, demand.

The October 1977 devaluation (29 percent for imported goods) led to an immediate jump in import prices; the ripple effects of this change, aggravated by the wage indexation arrangements, caused prices to spiral further at the beginning of 1978. Inflation at this time was running 7 percent higher, on an annual basis, than in the prereform months of 1977.

In residential construction, where supply is inelastic in the short run (due to the relatively long time it takes to build a home), the livelier demand for homes caused prices to shoot up throughout 1978. In other segments of the business sector too the stronger domestic demand generated pressure on prices in excess of that due to cost-push, primarily in the last quarter — evidence of the absence of spare productive capacity.

2. THE PRODUCT⁶ AND PRODUCTIVE CAPACITY

The gross domestic product expanded 5 percent in 1978. Although this fell short of the rates recorded in boom years (more than 10 percent annually), it eclipsed the figures

⁶ In recent years the product measured according to sectoral origin has differed from the figure obtained on the basis of resource uses (see Chapter II of the 1977 Bank of Israel Annual Report for a detailed explanation). Every measurement method has its advantages and disadvantages. The main deficiency of the calculation from the uses side is that the product is residually determined, accumulating all the errors in uses and imports. The errors in quantity are likely to be particularly large because the price rise in recent years has been ten times faster than the increase in quantity, and thus a relatively small price error will cause a large quantity error. The chief shortcoming in the sectoral measurement is the assumption of a constant import component from year to year (apart from

for the three preceding years, when the gain averaged about 2 percent p.a. In the past few years there was a slump in economic activity, touched off by the slackening of residential construction and aggravated by the more sluggish expansion of the public sector product. With the start of a comeback in the construction industry and the lifting of curbs in the public sector, the economy has begun to fare better. The growth trend in the business sector also points to a more vigorous expansion in 1978 — 5 percent compared with half this rate in the previous three years.

Analysis of the overall performance of the business sector shows, of course, dissimilar trends in the construction industry and the rest of the sector. Construction activity sagged noticeably, its product dipping 14 percent in each of the two preceding years. The industry began to perk up in 1978, as indicated by the number of new building starts. But since the data on dwelling investment do not fully reflect the extent of the recovery, the construction product made only a niggardly gain.

The rest of the business sector reveals a different picture. The slowdown here was not as severe, the product averaging 4.5 percent higher in each of the last three years, half the average advance in 1968–72 (and also 1961–64). In 1978 growth accelerated a bit to 6 percent. The weakening of the uptrend in recent years can be partly attributed to the dipping of the population growth curve from a 4 percent annual level at the beginning of the 1960s to 3 percent in 1968–72 and 2 percent in 1978. The working-age population underwent an even more pronounced change. Another factor in the more sluggish expansion of the sector's product was the alteration of its composition induced by a change in relative prices; this invariably depresses the product during the adjustment period.

It is important to determine how much slack capacity was created in the economy during the three preceding years which could have been taken up to meet the heavier domestic demand in 1978 without harming exports or aggravating inflation. Two indicators that may point to the existence of excess capacity are the ratio between the product and productive factors and factor productivity.

In construction the flagging of activity resulted in a smaller product per manhour and product per unit of capital. This was reflected by a sharp downturn in productivity⁷ (10 percent in 1977), accompanied by a decrease in the labor input. This gave rise to hidden unemployment and underutilization of equipment, thereby saddling the industry

agriculture). The product series according to the latter approach is apparently more consistent with the performance of the economy over time. For the purpose of the detailed analysis of the business sector presented here the sectoral data had to be examined, and so we chose to measure the product according to sectoral origin.

⁷ Productivity is measured using the Cobb-Douglas production function, with labor weighted 2/3 and capital 1/3.

TABLE II-2
GROSS DOMESTIC PRODUCT AT FACTOR COST,^a BY INDUSTRIAL ORIGIN, 1975-78

	1970 (IL million at current prices)	Percent annual real increase							
		Average				1975	1976	1977	1978
		1961-64	1966-67	1969-72					
1. Agriculture, forestry, fisheries	1,209	9.6	8.6	6.8	8.9	6.4	8.3	6.2	
2. Industry, mining, quarrying	4,215	14.3	-0.9	11.9	3.1	5.1	4.3	6.5	
3. Transportation and communication	1,856	11.0	0.0	13.4	-1.6	6.6	8.0	5.4	
4. Electricity and water	463	10.6	4.1	10.0	5.2	4.7	5.7	5.2	
5. Finance, trade, services	3,887	5.5	0.5	4.5	4.3	2.5	4.3	6.0	
6. Construction	1,784	12.3	-14.5	18.2	1.5	-13.7	-13.7	0.2	
7. Ownership of dwellings	1,582			3.7	8.4	8.7	6.0	4.5	
8. Public and community services	3,055			6.4	2.8	1.1	2.1	3.7	
9. Gross domestic product									
Total product	18,051			9.0	3.5	2.6	3.3	5.1	
Business sector ^b									
Incl. construction	13,414	9.6	-0.9	10.0	2.1	2.1	3.2	5.5	
Excl. construction	11,630	9.2	1.0	8.9	3.3	4.7	5.5	6.1	

NOTE: The real rates of change do not necessarily coincide with those in Table II-1 and II-6 since they have been calculated here according to industry.

a Before inventory and depreciation adjustments.

b Defined as the total product less public and community services and ownership of dwellings.

SOURCE: The sources for calculating the real rates of change are as follows:

- (1) Current account of agriculture, with the data converted from agricultural- into calendar-year terms, except for 1978, which has been calculated according to the agricultural year.
- (2) Index of industrial production.
- (3) As calculated in Chapter XV. In calculating the rates of change there the change in the output of each subbranch was weighted by its share in the 1972-73 product, as estimated on the basis of input-output data.
- (4) According to input-output data.
- (5) According to the rates of change in the labor input as measured by labor force surveys.
- (6) Construction output as calculated in Chapter IX.
- (7,8) According to national accounts data.

with excess capacity. But this does not permit a rapid response to increased demand because the long period of time required for building homes renders the supply inelastic in the short run and hence cannot keep prices from mounting in the immediate future. With the upsurge in demand for homes at the end of 1977, dwelling prices rocketed along with the stepped-up construction of new units.

The trend was different in the rest of the business sector. Here the labor input moved up closely in step with the product in 1975–77, and the product per manhour advanced more than 4 percent on average, similar to the figure in 1968–72. The capital stock, however, failed to keep pace, and this depressed productivity (from a 3.5 percent rate at the beginning of the 1970s to 2.5 percent in 1975–77).

Overall factor productivity can be more precisely estimated by netting out trade and services.⁸ This shows that the labor input adjusted to the growth of product in 1975–77, when the product per unit of labor averaged 6 percent higher, compared with a 7 percent average in previous periods of vigorous activity.

The capital stock generally fails to adjust to the product when the economy is slack. In 1975–77 the capital/product ratio rose, depressing productivity below the level of earlier boom periods.

In the business sector excluding construction and services, productivity ran at an average 6 percent rate in 1968–72, but sank to 3.5 percent in 1975–77. Part of this decline can be attributed to a change in the composition of human capital. In 1968–72 there was a significant improvement in the quality of the labor force as measured by investment in human capital (expenditure on education); but beginning in 1974 the picture changed noticeably (the stock of human capital rose at a 3 percent average rate in 1975–77, as opposed to 8 percent in 1968–72). This explains 2 percentage points of the drop in productivity between these two periods.

The growth of the product, coupled with the increases in labor input and product per manhour, points to the absence of disguised unemployment in the business sector excluding construction, and hence no slack capacity was created that can be taken up in the short run.

As for capital, the available data for 1976–77 reveal mixed trends in the various branches, with most of the increase being concentrated in those producing for export. It is therefore likely that the branches geared to the home market were saddled with unutilized capital, which can possibly be exploited in the long run when they increase

⁸ In trade and services (which constitute a quarter of the business sector excluding construction) productivity was assumed (incorrectly) to be zero; the nonexclusion of these branches will therefore bias the productivity figures.

their labor input. But there are some signs that in 1978 the capital stock expanded in all branches, including those oriented to the domestic market. This may indicate that part of the idle capital in these branches is no longer usable.

Two other developments attest to the absence of excess capacity in the short run in the business sector: (a) the movement of prices here, which toward the end of 1978 outpaced the rise in costs; (b) the development of commodity exports during the year, with those industries which boosted their domestic sales faring more poorly in the overseas market. In addition to the noncreation of any significant spare capacity in the business sector exclusive of construction, there was no excess supply of manpower at the real wage level paid this year, in contrast to the large excess supply during the recession in the 1960s.

These factors go a long way to explain the economy's performance in 1978. The business sector excluding construction expanded a little faster this year (6 percent), but the rate fell far short of that achieved during the emergence from the slump in the 1960s (close to 16 percent). Another reason for the disparity, beyond that stemming from the dissimilarity in the rate of increase of the population and its composition, was the possibility of absorbing a large number of workers in 1968 from the sizable reserve of unemployed (10 percent) and residents of the administered areas.

The 1978 growth rate slightly eclipsed that of the three preceding years in all branches of the business sector,⁹ but notwithstanding the sharpening of demand pressure this year, overall factor productivity drifted down. This can be ascribed to the expansion of the workforce in the business sector excluding construction and the insignificant gain in product per manhour.

We cannot fully explain the decline in productivity, which does not square with the recovery of economic activity. One possibility is that additional workers were hired so as to enable the industries to respond to a heavier demand in the future; another is that the GNP estimates are biased downward (see footnote 6) or that the labor force surveys are biased upward.

3. RESOURCES AND USES

USES

Total resource use was up nearly 7 percent in 1978, and excluding direct defense imports (which are for a specified purpose), the increase was about 5 percent. The higher

⁹ Apart from the slackening of growth in transportation and communication, and there are signs that the rate is biased downward; see the explanation in Chapter XV, "Transportation, Communication, and Tourism".

TABLE II-3
CHANGES IN GROSS DOMESTIC PRODUCT,^a FACTOR INPUT, AND PRODUCTIVITY OF THE BUSINESS SECTOR, 1975-78
 (percent annual increase)

	Average			1975	1976	1977	1978
	1961-64	1966-67	1969-72				
Business sector							
Gross domestic product	9.6	-0.9	10.0	2.1	2.1	3.2	5.5
Business sector, excl. construction							
Gross domestic product	9.2	1.1	8.9	4.1	5.1	5.5	6.1
Labor input	4.7	-3.9	3.7	-1.4	1.3	1.5	4.3
Stock of fixed nondwelling capital ^b	10.3	7.5	8.5	7.7	6.6	5.5	4.4
Productivity ^c	2.6	2.3	3.7	-1.9	1.9	1.8	1.6
Business sector excl. construction, trade, and services							
Gross domestic product	12.3	1.4	11.8	2.9	5.7	5.9	6.1
Labor input	4.5	-4.9	4.1	-3.4	0.5	-0.1	4.8
Stock of fixed nondwelling capital ^b	9.8	6.9	8.3	7.5	6.5	5.3	4.1
Productivity ^c	6.0	5.2	6.4	2.7	3.2	4.2	1.6
GDP/labor input	7.5	6.8	7.5	6.5	5.2	6.0	1.3
GDP/capital stock	2.3	-5.1	8.4	-4.3	-0.7	0.5	2.0

^a Measured according to industrial origin.

^b At the beginning of the year.

^c Labor weighted 2/3 and capital 1/3.

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

figures this year can be ascribed to the doubling of the growth rate in private consumption and the expansion of investment, which reversed the sharp downswing of the two preceding years. There was also a heftier public domestic spending. Not counting defense imports, domestic uses increased 6 percent. Exports, on the other hand, fared less well, their advance slowing, owing in some measure to the more buoyant domestic demand.

PRIVATE CONSUMPTION

Private consumption was 8 percent up on 1977. Since this was 2 percentage points more than the gain in national income, the saving rate dipped a little — a development probably indicative of the public's expectation that the economy would continue to perk up. An important factor in the accelerated expansion of private consumption was the large devaluation of October 1977, which unexpectedly and at one stroke greatly augmented the wealth of part of the public in Israeli currency terms, thus stimulating private demand.

The incremental private consumption was concentrated in consumer durables and spending by Israelis abroad, items which added 3 percent to the level of consumption. The adjustment of current incomes to changes in the public's permanent income is generally reflected in the timing of expenditures on these items (notably consumer durables because of their nature); and indeed, when real income failed to grow at the rate the public was used to, consumption of durables sagged (by a total of 20 percent over the three preceding years). With the economy starting to rebound and after a 6 percent real increase in incomes, the public is now making purchases which had been deferred.

INVESTMENT

The year reviewed saw a turnabout in investment activity — a growth of 4 percent or more (6 percent not counting the change in inventories), after the level had tumbled 25 percent in 1976--77. Spearheading the advance was private residential construction which, after shrinking noticeably in 1975--77, posted a modest increase this year. Non-dwelling investment also expanded at a relatively high rate, paced by a 15 percent increase in machinery and equipment.

The construction industry is characterized by cyclical fluctuations between boom and slump, due predominantly to the lagged adjustment of demand and supply because of the long building time.¹⁰ After the boom in the early 1970s, which resulted in the stock of dwellings under construction exceeding current demand, activity began to tail off in

¹⁰ For a detailed discussion of the cyclical pattern of the construction industry and its causes see the Bank of Israel Annual Report for 1975, Chapter VIII, "Domestic Investment".

TABLE II-4

CONTRIBUTION OF FINAL USES TO GROWTH OF TOTAL USES, 1976-78
(percent real change, at 1975 prices)

	1976	1977	1978
Private consumption	1.5	1.7	3.1
Public consumption, excl. direct defense imports	-0.5	-0.2	0.3
Civilian	0.4	0.2	0.4
Domestic noncivilian	-0.9	-0.4	-0.1
Gross domestic investment	-2.9	-1.7	0.7
Thereof: dwelling investment	-0.9	-1.3	-0.1
Exports	3.4	3.0	1.0
Excl. diamonds	2.8	2.9	1.6
Total uses, excl. direct defense imports	1.5	2.8	5.1

SOURCE: Central Bureau of Statistics.

1975 and in the next two years the number of starts plunged to a very low level, even short of that warranted by the normal demand for new homes. Consequently, the supply of completed units in 1978 failed to meet demand. This forced prices up, which in turn led to the expansion of new starts and the speeding up of work on units under construction. The number of private sector starts jumped more than 20 percent, with the recovery being felt most in the large cities, where the gain came to a formidable 50 percent. The total value of new private construction put in place was up 6 percent. In contrast to this, public sector investment in construction plummeted 25 percent. This reflected the sharp drop in starts in 1976 and 1977 and the failure to realize the planned volume of starts in 1978, owing to the lagged adjustment of public construction to the cyclical swing in the industry's activity.

Nondwelling investment expanded in both export industries and those geared to the domestic market. A sectoral analysis shows that all industries, both those oriented to the foreign and those to the home market, contributed to the higher figure. It is reasonable to assume that the impressive headway made in overseas sales in the past and the expectation that this trend would be sustained spurred investment in export industries. At the same time, the more buoyant domestic demands in 1978 made production for the home market more worthwhile than before, stimulating capital spending in industries manufacturing primarily for this market.

The resurgence of investment in 1978 did not seem to be justified, since the growth of GNP lagged behind that in the capital stock in the last few years. Two possible reasons can be advanced for the much heavier capital spending in 1978: one was the change in the production mix, which necessitated a larger amount of capital for the same quantity of output; another was the availability of cheap investment finance, which became increasingly worthwhile with the exacerbation of inflation (because of the decline in real interest compared with the period before 1973), thus necessitating a larger stock of capital.

PUBLIC CONSUMPTION

After two years of comparative restraint, evidenced by a 4 percent cumulative decline, public consumption exclusive of direct defense imports turned up this year by 2 percent quantitywise. Defense purchases were responsible for the slackening of the level in the past, and this year too this item continued to shrink, although to only a minor degree. By contrast, the public sector labor input continued upward in the two preceding years (by a total of 3 percent), and in 1978 the increase was higher yet.¹¹ This development was especially disturbing in view of the growth of domestic demands and the generation of demand pressure in the labor market. What is more, the expansion of the labor input has implications for the future: it will make it hard to dampen public sector demand because of the difficulty of discharging workers.

EXPORTS

Exports rose by a paltry 3 percent this year. The marked slowdown in diamond sales¹² was responsible for the poorer overall performance. Less this item, the gain came to a little more than 6 percent, only half the rate in the previous two years. This was the net result of a much more sluggish advance in commodities and a slight acceleration in services.

The positive impact which the bridling of domestic demands had on overseas commodity sales and their real exchange rate waned this year, and in fact the trend was reversed. During the period when demand tailed off the amount of spare capacity created was insufficient to enable the economy to meet the extra domestic demand in 1978, with the consequence that the growth of such demand was at the expense of foreign sales.

The foreign currency reform of October 1977 was supposed to influence exports in two ways. First of all, the differential rates of devaluation made it less profitable to produce goods for the foreign market compared with import substitutes, and it also made

¹¹ See footnote 1 above.

¹² The prices fetched by diamonds abroad soared 60 percent, so that the export of this commodity helped to improve Israel's terms of trade this year.

TABLE II-5

EFFECT OF RESOURCE USE ON THE BUSINESS SECTOR PRODUCT,^a 1975- 78
 (percentages, at 1972/73 prices)

	Distribution of the product by final use					Contribution of uses to growth of the product			
	1971	1975	1976	1977	1978	1975	1976	1977	1978
Private consumption	39.2	37.9	38.7	38.4	39.0	0.5	1.5	0.8	2.8
Public consumption	11.0	10.9	9.7	9.0	8.4	-0.4	-1.0	-0.4	-0.1
Gross domestic investment ^b	22.5	23.3	19.9	16.7	16.1	0.5	-3.0	-2.8	0.4
Exports	27.3	27.9	31.7	35.9	36.5	0.5	4.3	5.1	2.9
Excl. diamonds	25.5	26.2	29.2	33.2	34.2	0.3	4.0	4.8	3.0
Total product	100.0	100.0	100.0	100.0	100.0	1.0	1.8	2.7	6.0

NOTE: The data here have been calculated on the basis of input-output coefficients. In order to render them comparable with the data on resource uses, the latter have been adjusted downward as follows: private consumption excludes ownership of dwellings and compensation of employees (wages and salaries plus fringe benefits) of nonprofit institutions; public consumption excludes compensation of public sector employees; and exports exclude factor payments abroad, interest received by the public sector, and sundry domestic factor income. In addition, the direct import component has been deducted from all uses.

^a Gross domestic product at factor cost, excluding the product originating in public sector and nonprofit institution services.

^b Excludes changes in inventories. Because of this and the different definition and estimation methods used, the change in the business sector product in this table is not the same as that shown in Table II-1.

SOURCE: Central Bureau of Statistics data adjusted according to input-output data for 1972/73.

it less worthwhile to export goods which previously had not been profitable to the economy and could be done only thanks to the incentives awarded. Secondly, the floating of the Israeli pound created an atmosphere of uncertainty because of fluctuations in the rate due to short-term capital import movements. The uncertainty confronting exporters reduced the relative profitability of their sales, but since they were compensated by the provision of cheap credit, they probably enjoyed a higher profitability on balance.

Exports of goods (other than diamonds) edged up 2 percent in real terms, well below the increase posted in the two preceding years (an average of 17 percent). The slacker growth was due primarily to an absolute decrease in sales to the administered areas; those abroad rose nearly 9 percent. An input-output analysis shows that export value added was significantly larger this year. This was apparently due to the increased share of agricultural and service exports, which have a high value added, and also to the increased weight of domestic intermediates in industrial exports. The latter development is explained by the mounting profitability of industrial exports in the past and the decline in exports of goods unprofitable to the economy, which until the currency reform were supported by various forms of incentives.

In services the picture was different. They forged ahead 12 percent in quantity terms, similar to the figure in the previous two years. The large effective devaluation of October 1977 in the case of service exports (an average of about 40 percent) made them much more profitable. In tourism the devaluation was much smaller, with the result that the advance here was not as impressive. Most of the acceleration was in "other services",¹³ which benefited from the full extent of the devaluation.

RESOURCES

Total resources, excluding defense imports, were up about 5 percent, the same rate as for uses. Civilian imports expanded 6 percent and GNP by 5 percent. The share of imports in the total was thus a shade higher this year (for a discussion of the product see Section 2).

IMPORTS

The domestic market value of civilian imports rose 6 percent, but the main cause of this comparatively low rate was the precipitate fall in rough diamonds (30 percent in quantity terms). Despite its magnitude, the nominal import of diamonds does not affect economic activity to any noticeable extent. For this reason, and also because of speculative stockbuilding in the three preceding years, we shall examine imports exclusive of diamonds.

Disregarding diamonds, civilian imports expanded 10 percent quantitywise, after they had drifted up slightly in 1977 and slumped the year before. The increase was associated with the revival of demands and an expected resumption of economic growth. The increment was even greater than required for meeting the extra demand, because of a larger

¹³ Total services less tourism, transportation, insurance, and capital services. The statistical coverage of this category is not very good for lack of an administrative apparatus capable of measuring such activity. Hence this figure is apparently downward-biased.

TABLE II-6

NATIONAL PRODUCT AND INCOME,^a 1975-78
(IL million, at current prices)

	1975	1976	1977	1978	Percent annual increase		
					1976	1977	1978
Gross national product at market prices ^b	75,368	96,797	140,115	223,855	28.4	44.8	59.8
Depreciation	9,327	12,740	19,234	34,569	36.6	51.0	79.7
Net national product	66,041	84,057	120,881	189,286	27.3	43.8	56.6
Indirect taxes on domestic production ^c	8,722	13,527	18,673	29,658	55.1	38.0	58.8
Subsidies on domestic production	2,037	3,300	4,580	8,441	62.0	38.8	84.3
Subsidization of credit	6,476	8,805	13,549	24,738	36.0	53.9	82.6
National income	65,832	82,635	120,337	192,807	25.5	45.6	60.2

^a National income includes, for the first time, subsidies in the form of cheap credit, as estimated by the Central Bureau of Statistics (from 1975 onward).

^b At effective rates of exchange.

^c Includes the payroll tax, whose collection began in 1975.

SOURCE: Central Bureau of Statistics.

direct import this year and the sharply higher volume of raw material purchases abroad (14 percent) for building up inventories.

4. INCOMES

Disposable private income from domestic sources¹⁴ was 6 percent up on 1977 in terms of purchasing power, an outcome of the acceleration of economic activity on the one hand and a slight contraction of the overall tax burden on the other.

¹⁴ Before deducting net compulsory loans. Total net compulsory loans in a certain year consists mostly of collections of the Employers Loan, less redemption of loans collected in the past. The Employers Loan apparently does not constitute a tax, so that in calculating disposable income it should not be deducted. Redemptions of loans collected in the past should be added to disposable income, but no data are available on such receipts.

The tax burden¹⁵ declined 8 percent in real terms. This reflected a small real increase in total direct taxes (2.5 percent), which fell short of the expansion of domestic economic activity, and a larger real increase (4 percent) in net transfer payments.¹⁶

Disposable private income from all sources grew 7 percent in real terms. This is explained by a daunting 90 percent jump in personal transfer receipts from abroad, a development probably connected with the liberalization of foreign currency control, which, by allowing private individuals to hold foreign currency, induced many to transfer to this country currency that had previously been held abroad. Consequently, this increase was probably a one-time affair.

The rate of private saving dipped slightly in 1978 after it had risen the year before, but not as fast as usual in the period before 1973. The poorer saving performance in the year reviewed may have been indicative of the expectation that the economy would continue to recover and of the advancing of consumption in anticipation of a larger income in the future.

In the distribution of income from economic activity the share of wages declined fractionally following two years of significant advance. The sharp fall in the capital share of national income in 1976–77 partly reflected the slowing of the economy because of the weakening of demands. For the first time, the Central Bureau of Statistics this year estimated the subsidy element in capital, after it had grown to sizable proportions with the sharpening of inflation. At the beginning of the 1970s the subsidization of capital apparently did not greatly affect the distribution of income, so that its share this year was not much smaller than at the beginning of the decade (see the table below).

SHARE OF WAGES IN NATIONAL INCOME^a
(percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Share of wages in national income, ^b excluding the subsidization of capital	65	63	61	65	64	65	72	74	73
Share of wages, including the subsidization of capital						58	63	65	63

^a Excludes the net product of housing services at factor cost.

^b Excludes the imputed net rental value of owner-occupied dwellings and the imputed wages of self-employed.

¹⁵ Income tax and national insurance contributions, less net transfer payments.

¹⁶ Transfer payments rose this year, mainly because of a higher interest outlay on account of loans falling due.

TABLE II-7
GROSS DISPOSABLE PRIVATE INCOME, 1975-78
(IL million, at current prices)

	1975	1976	1977	1978	Percent annual increase		
					1976	1977	1978
1. National income	65,832	82,635	120,337	192,807	25.5	45.6	60.2
2. Public sector property and entrepreneurial income ^a	1,463	2,556	4,573	5,481	74.7	78.9	19.9
3. Public sector interest income from subsidized credit	6,476	8,805	13,549	24,738	36.0	53.9	82.6
4. Depreciation	9,327	12,740	19,234	34,569	36.6	51.0	79.7
5. Gross private income from economic activity (1-2+3+4)	67,220	84,014	121,449	197,157	25.0	44.6	62.3
6. Income tax (incl. surtax on inventories) ^b	10,151	17,125	23,609	36,625	68.7	37.9	55.1
7. National insurance contributions ^c	4,077	6,147	9,583	15,751	50.8	55.9	64.4
8. Total direct taxes (6+7)	14,228	23,272	33,192	52,376	63.6	42.6	57.8
9. Net transfer payments ^c	12,995	18,488	27,419	44,247	42.3	48.3	61.4
10. Gross disposable income from domestic sources ^d (5-8+9)	65,987	79,230	115,676	189,028	20.1	46.0	63.4
11. Personal transfers from abroad	4,627	5,452	8,797	16,437	17.8	61.4	86.8
12. Gross disposable private income from all sources	70,614	84,682	124,473	205,465	19.9	47.0	65.1

^a Excluding revaluated profits of the Bank of Israel in foreign currency.

^b Excluding the change in the balance due under the tax debt payment arrangement.

^c Including collection of employers' matching contributions.

^d Before deducting net compulsory loans.

SOURCE: Central Bureau of Statistics and Bank of Israel.

TABLE II-8
GROSS PRIVATE SAVING,^a 1975--78
(IL million, at current prices)

	1975	1976	1977	1978	Percent annual increase		
					1976	1977	1978
Gross disposable private income from domestic sources ^b	65,987	79,230	115,676	189,028	20.1	46.0	63.4
Gross disposable private income from all sources	70,614	84,682	124,473	205,465	19.9	47.0	65.1
Private consumption	46,408	62,078	88,110	146,696	33.8	41.9	66.5
Gross private saving from domestic sources	19,579	17,152	27,566	42,332	-12.4	60.7	53.6
Gross private saving from all sources	24,206	22,604	36,363	58,769	- 6.6	60.9	61.6
Percentages							
Rate of gross saving from domestic sources	29.7	21.6	23.8	22.4			
Rate of gross saving from all sources	34.3	26.7	29.2	28.6			

^a Of households, business, and nonprofit institutions.

^b Before deducting net compulsory loans.

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

TABLE II-9
NATIONAL SAVING, 1975-78
 (IL billion, at current prices)

	1975	1976	1977	1978
1. Gross private saving from domestic sources	19.6	17.2	27.6	42.3
2. Public sector saving	-24.6	-23.4	-27.5	-56.5
Net public sector income	9.4	17.6	24.4	34.8
Public consumption	33.9	40.9	51.9	91.4
3. Gross national saving from GNP (1+2)	-5.0	-6.2	0.1	-14.2
4. Unilateral transfers from abroad ^a	10.2	16.2	19.5	34.4
5. Gross national saving from all sources (3+4)	5.2	10.0	19.6	20.2
6. Depreciation	9.3	12.7	19.2	30.6
7. Net national saving from NNP (3-6)	-14.3	-19.0	-19.1	-44.8
8. Net national saving from all sources (5-6)	-4.1	-2.7	0.4	-10.4
	Percentages			
9. Rate of gross saving from GNP	-6.6	-6.4	0.1	-6.3
10. Rate of gross saving from all sources	3.9	5.9	8.1	4.8
11. Rate of net saving from NNP	-21.7	-22.6	-15.8	-23.2
12. Rate of net saving from all sources (less depreciation)	-3.3	-1.7	0.2	-2.7

^a Less net interest payments of the public sector.

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