CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

Total resource use continued to expand rapidly in 1971, even though all reserves of idle factors of production had been fully tapped since the previous year. This growth in final uses was accompanied by a pronounced change in their composition: exports made impressive headway, investment rose strongly, while public and private consumption moved up at a comparatively sluggish rate. As a result of the big gain in exports and the sagging growth of imports, the balance of payments deficit on current account was whittled down by $90 million, reversing the rising trend begun in 1966.

The growth of aggregate demand was due partly to developments in foreign markets, which resulted in a heavier demand for Israeli exports, but it was also connected with the continued expansionary influence of public sector operations, the sharply larger capital import by the private sector, the accumulation of foreign currency reserves, and the rapid growth of the money supply and other liquid assets held by the public, especially after the devaluation of August 1971.

The increased aggregate demand led to heavier pressure on available productive factors, overemployment in the labor market, and a slightly faster expansion of the national product, accompanied by the intensification of inflationary pressures in the economy and a consequent steep rise of prices. However, despite the notable growth of disposable private income and of liquidity in the economy, the average annual level of private consumption increased at a very sluggish rate. The inflationary tendencies became even more acute toward the end of 1971 and the early months of 1972, when private consumption and imports began to move up at a faster pace and prices continued to mount to a degree not warranted by the devaluation. Nevertheless, it appears that the stimulative factors had not yet found full expression by year's end.

At constant prices, the national product was up 9 percent in 1971, compared with 8 percent the year before. Along with the rapid growth of GNP, there was a greater demand for labor, which was only partly met by the 3.5 percent increase in the number of Israeli employed (which had risen 1.8 percent in 1970). The latter increase is partly attributable to the expansion of the working-age population, but it also reflected the mounting pressure in the labor market. The labor force participation rate first stabilized and then moved ahead, after having fallen uninterruptedly for a number of years, while the unemployment rate continued to drift downward – from 3.8 percent in 1970 to 3.5 percent. Another part of the additional demand for labor was supplied by the administered areas, which in 1971 accounted for one quarter of the entire increment of gainfully

Table I–1

MAIN ECONOMIC INDICATORS, 1966-71

(percentages)

	Annual increase or decrease (–)						
	Average 1961-65	1966	1967	1968	1969	1970	1971
Resources and uses (at constant prices)							
Total domestic uses	10.5	–0.8	3.7	16.5	14.7	11.3	5.9
Gross national product	10.2	1.6	2.7	14.0	12.0	8.0	8.8
GNP per capita	6.1	–1.0	–0.5	10.2	9.2	5.1	5.7
Private consumption	10.3	3.1	1.4	11.3	10.8	3.4	4.4
Private consumption per capita	6.1	0.5	–1.7	7.6	8.0	0.6	1.5
Public consumption	10.6	8.3	36.1	8.9	16.1	27.8	–0.3
Gross investment	11.3	–16.1	–22.0	48.2	23.8	11.7	17.6
Balance of payments,[a] excl. trade with administered areas (in dollars)							
Imports	12.0	3.8	10.6	24.4	20.7	21.4	13.6
Exports	15.6	16.6	6.5	21.7	11.7	8.6	32.7
Import surplus	8.8	–14.4	18.4	29.0	35.6	39.0	–6.7
External debt	13.7	7.7	17.8	22.2	11.6	23.4	30.8
Foreign exchange reserves[b]	27.7	–3.5	13.7	–7.2	–46.0	6.6	59.5
Population and employment							
Average population	3.9	2.6	3.2	3.4	2.6	2.8	2.9
Number of employed	4.8	–0.6	–4.3	9.0	3.8	1.8	3.5
Unemployed job-seekers	–0.3	109.3	39.3	–39.0	–24.9	–13.8	–6.5
Prices and national income (nominal)							
Average monthly earnings per employee[c]	13.6	19.1	0.2	3.2	5.2	9.0	15.3
Earnings per man-hour[c]	13.3	19.8	3.3	–0.3	3.7	10.2	15.5
GNP prices	8.0	8.3	1.4	2.4	2.7	8.9	13.2
Consumer price index (annual average)	7.4	8.0	1.6	2.1	2.5	6.1	12.0
National income	18.8	9.0	4.1	18.5	14.9	17.0	23.2
National income per capita	14.3	6.2	0.9	14.6	12.0	13.8	19.7
Finance							
Money supply (annual average)	17.6	7.3	20.3	19.0	7.1	5.0	22.4
Bank credit to the public and bill brokerage credit (annual average)[d]	19.6	22.9	19.0	12.4	19.7	17.3	23.4

[a] Goods and services; imports c.i.f., exports f.o.b.

[b] Foreign currency balances in the Bank of Israel at the end of the year.

[c] Since 1969 a new series based on National Insurance Institute data, which include East Jerusalem.

[d] In 1961-63 bank credit only.

employed from all sources. Altogether, the labor input grew by 4.4 percent, compared with 2.3 percent in 1970. The gross domestic product per man-hour advanced 4.4 percent, after a 5.4 percent gain in the preceding year.

Despite the appreciably larger labor input, some of the additional demand for workers apparently remained unsatisfied. This was reflected by the sharp rise in the number of unfilled job openings, as well as by very sizable wage and salary hikes. Labor costs per man-hour were up 17 percent in 1971, after rising 14 percent in 1970, and in the course of the year reviewed employees' earnings increased well in excess of the provisions of the collective agreements. However, average earnings per man-hour did not outstrip the growth of GNP per man-hour at current prices, but even lagged somewhat behind. This strengthens the conclusion that the deviations from the collective agreements were not due solely to pressure on the part of the workers.

Another manifestation of the more acute inflationary pressures prevailing in the economy as it approached full employment was the accelerated rise of the price level, as reflected by the various price indexes. The advance was rapid even compared with the boom years before the 1966-67 recession: from the middle of 1970 until the end of December 1971 the level rose 23 percent. Part of the increase was connected with the dearer cost of imports after the imposition of a 20 percent surcharge in August 1970 and the devaluation of the Israeli pound in August 1971. But prices went up not only immediately after the rise in import prices but throughout the rest of the period discussed, as well as in the early part of 1972. There were also strong increases in some items not affected by import prices, such as housing, various services, and agricultural products. Prices of domestic uses (private consumption, public consumption, and investment), net of indirect taxes and the rise in import prices, advanced 9-10 percent in 1970 and by a further 12 percent in 1971, after moving up by 0.3, 0.6, and 2.5 percent in 1967, 1968, and 1969 respectively.

As for the causes of the higher aggregate demand, most of the upward thrust emanated from commodity and service exports. At constant prices, total exports soared 25 percent in 1971, compared with 9 percent in the previous year. Their direct contribution to the growth of the national product is estimated at over 50 percent. Most branches shared in the rapid expansion of exports, but especially strong gains were posted by tourism and transportation services, citrus, and diamonds. This extraordinary export increment was to some extent made possible by developments in foreign markets; another major contributory factor was the cumulative effect of the rise in the relative profitability of exports in recent years, following the upward revision of the effective exchange rate for exports.

Gross domestic capital formation likewise showed an impressive advance in 1971 – 18 percent (at constant prices) as opposed to 11 percent the year before. This acceleration reflects the steep increase in direct investments by the Government, after being cut back in 1970. On the other hand, private investment expanded more sluggishly in the year reviewed despite the much larger amount of Government-directed long-term financing provided at low interest. The biggest increase was in nondwelling investment, which was up 22 percent at constant prices, compared with only 4 percent in 1970. Even if ships and aircraft (investment in which expanded appreciably in 1971) are excluded, the growth of nondwelling investment still stands out – 9 percent as against 1 percent in 1970. The bulk of the investment exclusive of ships and aircraft was made in trade and services, land transport, communications, and construction equipment.

Residential construction continued to expand rapidly, but the value of such construction put in place went up at a much lower rate in the year reviewed – 16 percent vs. 35 percent in 1970. These figures, which were affected by completions of units started in previous years, do not reflect the formidable growth of demand for housing during 1971. This was greater than what might have been expected in view of the expansion of the population and immigration, even if the improvement in living standards and the shelving of purchases during the recession and the years immediately thereafter are taken into account. The abundant liquidity in the economy in general, and the much greater amount of mortgage and other credit granted home buyers and contractors in particular, along with the large volume of foreign investment and capital transfers, also fueled demand. As a result of this development, housing prices spurted 36 percent during the year, and private residential starts expanded noticeably. The expectation that housing and land prices would continue upward attracted more investments in real estate, spurred by the hope of reaping a quick and handsome profit.

In contrast to the vigorous growth of exports and investment, there was a comparatively mild increase in consumption. At constant prices, total consumption was up only 2.7 percent in 1971; the rise in private consumption was 4.4 percent, or about 1.5 percent per capita, while public consumption edged down 0.5 percent. The decline in public consumption mainly reflected the contraction of security expenditure abroad, for net of defense imports there was actually an increase of 8.7 percent in total public consumption and of 5.3 percent in civilian public consumption. This comparatively modest rise in private consumption (for the second consecutive year) despite the rapid uptrend in economic activity and real incomes cannot be fully explained at this stage.

As regards 1970, one reason was the appreciable 51 percent upsurge in tax and compulsory loan collections from the public, as contrasted with a nominal rise of only 18 percent in gross income from all sources and of 12 percent in disposable income (equivalent to only 1 percent per capita at constant prices). While a slowdown in disposable income tends, as a rule, to affect consumption habits only with some lag, it seems that in 1970 the impact of the absorptive measures was felt fairly quickly. Though the public sector continued to siphon off funds from the public in 1971 on a large scale (an increase of 38 percent), gross income from all sources rose 26 percent, so that the growth of private disposable income was not seriously affected (it went up 23 percent at current prices, or 6 percent per capita at constant prices).

The explanation of the much better saving performance of the private sector in 1971 must apparently be sought in three factors operating during the year. First, the sluggish growth of private disposable income in 1970 presumably continued to influence consumption spending in the early months of 1971, and the latter began to pick up only later, in particular toward the end of the year. Second, part of the additional income in 1971 was accounted for by a relatively small number of branches which enjoyed exceptionally high earnings in the export markets – among them citriculture, the diamond industry, tourism, and international transport services. Presumably the bulk of their extra profits was not utilized for current consumption. Third, the much heavier home buying, spurred by the prospects of earning a quick profit in the wake of soaring real estate prices, was partly financed from current income, at the expense of current consumption. At the same time, however, it should be stressed that there was also an increase in liquid savings, such as assets linked to the consumer price index and deposits linked to the foreign exchange rate, as well as in saving through social insurance funds and insurance companies.

The spurt in consumption in the latter part of 1971 and the first months of 1972 suggests that the mild average rise in private consumption during 1971 did not signal the start of a new trend, but was the outcome of special factors. The sizable expansion of exports and the slower growth of imports shaved off $90 million from the adverse balance on goods and services account – from $1,282 million in 1970 to $1,196 million. At current prices, total exports were up 33 percent, with commodities scoring a 24 percent gain and services 42 percent. Imports increased by 14 percent, compared with over 20 percent in each of the years 1968-70. Direct imports of defense goods were cut back by some $100 million. Excluding the latter item, the rise came to 23 percent at current prices and 19 percent at constant prices.

Most of the appreciable growth of civilian imports in 1971 was accounted for by two items closely connected with the expansion of exports: rough diamonds and ships (imports of the latter reflected the expansion of the Israeli tanker fleet following the opening of the Eilat-Ashkelon oil pipeline). Imports of inputs were up 8 percent at constant prices, which was about what might have been expected on the basis of constant input coefficients for the various branches of the economy. The higher cost of imported goods and services in the domestic market following the imposition of a 25 percent import surcharge in August 1970 and the devaluation of the Israeli pound in August 1971 does not seem to have resulted so far in any significant substitution of local for foreign products. Long-term capital imports grew in 1971 by $300 million, continuing the rapid upswing of the previous year. But there were changes in the sources of growth, as well as in the ratio between capital imports and the adverse balance on current account.

In 1970 the public sector was responsible for most of the additional capital imports, a development connected with the expansion of noncivilian imports, whereas 1971 saw a notable increase in capital imports of the private sector. The latter development partly reflected the more energetic effort made to raise capital abroad in view of the dwindling of the economy's foreign exchange reserves in 1969 and 1970 and the expectation that this trend would persist in 1971. The devaluation of August 1971 further stimulated capital imports, since it increased the Israeli pound value of imported capital and reduced the risk of another imminent devaluation. Unilateral transfers were, at about $800 million, up sharply from their 1970 level, and covered two-thirds of the current deficit. But even with this unprecedented inflow of unilateral transfers, it was still necessary to raise some $400 million in foreign investment and loan capital in order to finance the remainder of the deficit. All told, foreign investments and long-term borrowings went up by a very respectable $760 million, as against $613 million in 1970 and only $214 million in 1969. Capital imports added up to $1,560 million, exceeding the current deficit by approximately $360 million. This was reflected by a $215 million increase in foreign currency reserves held at the Bank of Israel (after they had shrunk by $266 million during the years 1968-70), as well as by other changes in the economy's short-term foreign currency assets and liabilities.

The much larger inflow of capital in 1971, part of which was intended for dwelling and nondwelling investment, explains much of the growth of aggregate demand and economic activity. But the stimulative influence of capital imports was not confined to the direct financing of investment; it was also reflected in the expansion of foreign currency reserves at the Bank of Israel, which in turn was the major factor increasing the liquidity of the economy and the money supply. Altogether, net foreign currency assets of the Bank of Israel (including devaluation increments) swelled by IL 1,074 million. Various signs indicate that the source of the increment was the nongovernmental sector, whose capital imports far exceeded the current deficit in its balance of payments. Moreover, the devaluation of the Israeli pound and the upward revaluation of the German mark brought large capital gains to holders of Pazak and Tamam foreign currency deposits. The consequence was a big growth in these deposits and some increase in the amounts converted (especially from Pazak balances not originating in German restitution payments).

In contrast to the private sector's foreign currency surplus, the Government's expenditures far outstripped its receipts in foreign currency. However, its foreign currency deficit did not have a restrictive effect on monetary expansion since, along with its net purchase of foreign currency, the Government increased its debt to the Bank of Israel (including the revaluation of linked liabilities) by IL 1,422 million. The total external infusion of liquidity into the economy originating from the accumulation of foreign currency reserves and from credit granted to the Government reached IL 2,493 million in 1971, as against IL 922 million the year before.

To be sure, part of the incremental foreign currency holdings of the Bank of Israel derived from transfers of personal restitution, personal remittances by new immigrants, and certain other receipts, which were deposited in commercial banks and redeposited with the Bank of Israel. But even ignoring such deposits, the liquidity infusion was on such a scale as to necessitate the introduction by the central bank of measures to siphon off purchasing power in order to restrain the monetary expansion and limit the potential growth of credit to the public following the increase in the banking institutions' liquidity. The required liquidity ratios on demand and time deposits were raised in May, June, and December 1971, and again in February 1972. The participation of the commercial banks in the Export Finance Fund was increased in April and September 1971, with that of the Bank of Israel being reduced correspondingly. Net sales of the Short-Term Loan were stepped up, especially between August and October, after the yield was increased. The postdevaluation hike of the interest rate on liquidity surpluses kept at the Bank of Israel also helped to check the credit expansion, since it encouraged banks to run surpluses. As a consequence, the liquidity ratio actually maintained by the banking institutions against demand deposits went up from 38.2 percent at the end of 1970 to 48.2 percent at the end of 1971 and to 49 percent at the end of February 1972. This was in addition to the increase of five percentage points in the required liquidity ratio against IL time deposits. Debitory and creditory interest rates rose by 1-1.5 percentage points over the year, but owing to the strong inflation, real interest fell and for various types of directed credit was even negative.

Despite the various measures taken by the Bank of Israel to counter inflation, there was a rapid rise in the main monetary aggregates – the money supply, other liquid assets of the public, and credit granted to the public. The quantity of money was up 28.2 percent, after expanding by 14 percent in 1970 and only 2.5 percent in 1969. Other liquid assets of the public (time deposits in Israeli and foreign currency, approved saving scheme accounts, and the Short-Term Loan) soared 34.9 percent, compared with 23.2 and 21.8 percent in 1970 and 1969 respectively. Credit extended to the public by commercial banks and the Bank of Israel was 22.2 percent over the 1970 level, compared with rises of 20.7 and 20.3 percent in the two preceding years.

The financial operations of the public sector did not have more of an expansionary effect in 1971 than in the preceding year, either as regards the contribution of the sector's demand surplus to aggregate domestic demand or as regards the pumping of liquidity into the economy. However, since both the demand surplus and the liquidity infusion plateaued at a high level in 1971, this stabilization could not offset the inflationary effects of the balance of payments improvement and accumulation of foreign currency balances by the private sector when the economy reached a state of full and even overemployment, especially after the devaluation of August 1971.

Public sector tax revenue jumped 36.5 percent in 1971 – the fastest rate in many years. This increase is explained by the direct and indirect tax hikes which went into effect in the course of 1970 and found full expression in 1971, as well as the smaller increases in the latter year, including the raising after devaluation of ad valorem taxes. Adding compulsory loan collections to the public sector's tax revenue brings the gain up to 41 percent, compared with 37 percent in 1970 and 23 percent in 1969. Tax and compulsory loan receipts amounted to 41 percent of the gross national product in 1971, as against 36 percent in 1970 and only 28 percent in 1967. Along with the strong growth of revenue from these sources, the year reviewed witnessed a still more rapid rise in Government transfer and subsidy payments to the general public. Net of such payments, the amount absorbed from the public increased at a milder rate than in 1970, though faster than the growth of private incomes.

Public sector consumption was up 15.3 percent at current prices, as contrasted with 37.1 percent in 1970, while the sector's demand surplus (not counting compulsory loans) rose 5 percent to stand at IL 3,873 million. As regards the Government's credit operations, the volume of development budget loans granted was stepped up by IL 162 million to IL 1,408 million. The stimulative effect of such credit is similar to that of direct Government investments, since a large proportion of the loans is directly connected with the implementation of Government investment projects, such as housing. In this context it should be noted that long-term lending by financial institutions in accordance with

Government instructions also expanded considerably, and this was a further factor increasing liquidity and aggregate demand in the economy.

Transfer receipts from abroad and credit from the banking system covered IL 3,793 million of the public sector deficit, about the same sum as in the preceding year. There was a slight change in the shares of the two component items, that of foreign sources declining somewhat and the weight of domestic bank credit rising. The direct impact of public sector operations on the economy's liquidity – i.e. bank credit received, less the sector's contractionary influence on foreign exchange reserves – totalled IL 893 million in 1971, roughly the same as in the two preceding years. However, the similarity in the volume of liquidity pumped into the economy during the last two years must be viewed against the backdrop of the rapid monetary expansion which began in the second half of 1970 and was fed by the generally favorable developments in the private sector's balance of payments.

To sum up, there were a number of positive developments in 1971, which can largely be credited to the economic policy followed in recent years. Most striking was the big stride forward in exports. Though this can be partly attributed to special factors at work in foreign markets during 1971, its main cause was the deliberate policy of boosting the profitability of exports as compared with production for the domestic market – a policy consistently applied during the past several years. For the first time since the economic slowdown of 1966-67, there was a decrease in the current-account deficit in the balance of payments, and the accelerated expansion of exports relative to imports reasserted itself – a trend on whose continuation hinges the country's progress toward economic independence. The slackening of the growth of private consumption (for the second year running), despite the strong upswing in economic activity, reflected, at least partly, the increased absorption of purchasing power by the public sector through direct and indirect taxes and compulsory loans – a trend begun in 1970 and whose main effect found full expression only in 1971.

Nevertheless, since the restraining influence of the fiscal measures mentioned was accompanied by a further sizable demand surplus and large-scale infusion of liquidity by the public sector, they could not prevent the generation of inflationary pressures as the economy approached a state of full employment and even a considerable excess demand for labor. What is more, the positive developments in the country's balance of payments – which brought about a renewed buildup of foreign exchange reserves after they had been heavily depleted in 1968-70 – in themselves sparked a monetary expansion on a scale unknown since the early sixties and led to steep price and wage increases. These inflationary pressures grew sharper after the devaluation, which came at a time of full employment and a surging inflow of unilateral receipts, investment capital, and long-term loans from abroad. Under such conditions, the policy of monetary restraint implemented by the Bank of Israel during the year reviewed and at the beginning of 1972 could not forestall a rapid growth of the money supply and other liquid assets of the public, which carried over into the early months of 1972.

While the intensification of inflationary tendencies and the appreciably greater liquidity did not find full expression by year's end in the level of aggregate demand and prices, their initial repercussions could be seen in the rise in private consumption, the further strong uptrend of prices even after the impact of the devaluation on import prices had worn off, the growing tightness in the labor market, and the accelerated expansion of imports.

To check these inflationary tendencies necessitates the adoption of restraining measures in various economic spheres. These measures were spelled out in the report of the Governor of the Bank of Israel on the increase in the money supply between June 30, 1971 and February 29, 1972, which was submitted to the Government and the Finance Committee of the Knesset.

Immediate implementation of a policy designed to ease inflationary pressures may help to sustain the positive developments in the balance of payments while permitting vigorous economic growth. On the other hand, further monetary expansion, an excessive rise in aggregate demand, and a consequent continuation of the price-wage spiral are liable to retard the growth of exports, accelerate imports, and entail even more stringent measures, which in turn may detrimentally affect the rapid growth of the economy and ultimately bring on serious unemployment.