

CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

THE YOM KIPPUR WAR divided the year 1973 into two distinct periods differing widely from each other with respect to the factors and trends operating in the economy. Economic activity in the fourth quarter was greatly influenced by the hostilities and the ensuing security situation, and hence it did not see a continuation of the trends prevailing in the prewar months. To combine these two subperiods would blur their vastly different characters, and therefore they will be analyzed separately.

The inflation grew sharper in the first nine months of 1973, owing to the accumulated effect of the excess demand prevailing in the economy, which was fueled by the rapid monetary expansion begun in mid-1970. An important factor in the aggravation of inflationary pressures in the first three quarters of the year reviewed was the change in consumers' behavior: private consumption per capita rose 9 percent following a decline in the rate of saving out of disposable private income. The intensification of the demand-inflation was reflected by a doubling of the rate of price increase during the year, which in turn was partly responsible for adding some \$ 500 million to the import surplus.

Despite these developments, the uptrend in the gross domestic product slowed from 10 percent in each of the two preceding years to 8 percent in the first nine months of 1973. This can mainly be ascribed to the fact that all manpower reserves were fully tapped (in the short run), and also to special factors which affected agriculture, tourism, and residential construction.

With the outbreak of hostilities in October and the extensive mobilization of manpower and equipment (especially trucks), economic activity sagged. The decline was sharpest during and immediately after the fighting, and was accompanied by changes in the pattern of demand: heavier purchases of the output of several sectors and branches and a drop in others. Against this backdrop, severe dislocations were to be expected—grave shortages in branches and sectors where productive capacity was especially hard hit compared with demand, and frictional unemployment in those experiencing a noticeable dampening of demand. Preliminary estimates of the product of the private economy in the final quarter of the year show it to be 8 percent below the average for the first nine months of 1973—a milder decline than that of manpower caused by the general mobilization. Even if we accept this estimate with reserve, it seems that the civilian economy did not suffer grave disruptions,

Table I-1
MAIN ECONOMIC INDICATORS, 1966-73^a

(percent annual increase or decrease [-])

	Average 1961-65	1966	1967	1968	1969	1970	1971	1972	1973	
									Jan.- Sept.	Entire year
Resources and uses (at constant prices)										
Total domestic uses	10.5	-0.8	3.7	16.6	14.9	11.2	7.7	5.9	12.7	18.4
Gross domestic product ^b	10.0	1.4	2.5	14.7	12.4	8.3	10.1	10.2	8.4	7.1
Gross domestic product—private economy (excl. residential rents) ^c	10.9	-0.6	0.4	19.1	14.7	9.1	11.8	11.9	9.0	5.6
Gross domestic product per employed	5.0	2.0	7.2	4.7	7.5	5.4	5.1	3.3	3.4	2.2
Private consumption	10.3	3.1	1.5	11.3	10.3	3.0	5.1	8.8	12.4	8.5
Private consumption per capita	6.1	0.5	-1.7	7.6	7.5	0.2	2.0	5.3	8.8	4.9
Public consumption	10.6	8.3	36.1	8.9	16.7	26.3	1.3	-1.9	0.5	44.8
Gross investment	11.3	-16.1	-22.0	48.2	25.2	13.5	21.4	8.7	24.9	12.5
Balance of payments,^d excl. trade with ad- ministered areas (in dollars)										
Imports	12.0	3.8	10.6	24.5	20.8	21.1	16.3	5.1	41.7	60.5
Exports	15.6	16.6	6.5	21.7	11.7	7.6	33.3	17.4	31.8	23.8
Import surplus	8.8	-14.4	18.4	29.0	35.6	39.7	-1.6	-12.4	61.7	130.8
External debt	13.7	7.7	17.9	22.2	11.7	23.4	30.8	19.0	25.1	24.8
Foreign exchange reserves ^e	27.7	-3.5	13.7	-7.2	-46.0	6.6	59.2	86.0	56.0	58.7

Population and employment

Average population	3.9	2.6	3.3	3.4	2.6	2.8	3.0	3.3	3.3	3.4
Number of Israeli employed	4.8	-0.6	-4.3	9.0	3.8	1.8	3.5	5.0	3.9	3.9
Unemployment rate (as a percent of civilian labor force)—absolute figures	3.6	7.4	10.4	6.1	4.5	3.8	3.5	2.7	2.4	2.6

Prices and national income (nominal)

Average monthly earnings per employee post ^f	13.6	19.1	0.4	3.2	6.1	9.0	16.4	14.4	24.9	—
GNP prices	8.0	8.3	1.4	2.8	2.9	9.4	13.3	14.2	19.7	21.1
Import prices ^g	9.7	2.5	1.7	12.9	6.2	4.2	16.2	20.7	17.7	21.3
Consumer price index (annual average)	7.4	8.0	1.6	2.1	2.5	6.1	12.0	12.9	18.5	20.0
National income	18.8	9.0	4.0	18.7	15.0	17.7	24.7	25.7	30.2	29.7
Disposable private income ^b	18.4	7.8	8.4	15.3	16.1	10.3	22.2	29.1	30.9	30.1

Finance (annual average)

Money base ¹	18.9	5.1	22.8	22.6	4.0	9.0	34.6	47.5	21.8	24.0
Money supply	17.6	7.3	20.3	19.0	7.1	5.0	22.4	30.1	22.6	25.3
Other liquid assets of the public ¹	32.5	20.7	26.7	32.6	23.9	23.3	29.8	27.6	20.8	19.9
Bank credit to the public and bill brokerage credit	19.6	22.9	19.0	12.4	17.4	18.3	24.1	17.4	28.4	29.0

^a Until 1968 the percentage changes were calculated on the basis of the previous year's prices, but since 1969 the rates of real change have been calculated on the basis of constant 1970 prices.

^b Valued at the effective rate of exchange.

^c Defined as the total product, less public sector and nonprofit institution services.

^d Goods and services (imports c.i.f. and exports f.o.b.).

^e Net foreign currency balances in the Bank of Israel at the end of the year.

^f Israeli employee posts, including part-time and supplemental work. Since 1969 a new series based on National Insurance Institute data, which includes *inter alia* East Jerusalem.

^g Including changes in foreign prices and in the effective exchange rate of the Israeli pound.

^h Gross disposable private income from domestic sources, net of compulsory loans.

¹ Currency in circulation with the public, plus total liquid assets of the banking institutions.

² Time deposits in Israeli and foreign currency, saving scheme deposits, bill brokerage, and the Government Short-Term Loan.

and by year's end economic activity had apparently bottomed out at a somewhat lower level.

With the partial release of manpower and equipment and the return of demand to its prewar level, economic activity picked up strongly, and at the beginning of 1974 signs of excess demand again began to appear in numerous areas of the economy.

The accelerated rise of prices, at a rate unheard of in previous boom periods, is reflected in the various price indexes: during the first three quarters of 1973 the consumer price index jumped 18 percent (an annual rate of 25 percent), while wholesale prices of industrial output and residential construction input prices moved up even faster. These increases, which greatly eclipsed those in Western Europe and the United States, resulted first and foremost from demand pressure in the Israeli economy, where the unemployment rate fell to an all-time low.

The spiralling of domestic prices was partly due to a precipitate advance in import prices, for the third year running—a result of the imposition of various levies, a decline in the external value of the Israeli pound, and sharply higher prices in foreign markets. Between mid-1970 and September 1973 import prices shot up by a total of 65 percent. Such an increase in an economy like Israel's, which is heavily dependent on overseas purchases, pushes up the cost of numerous domestic commodities produced partly from imported materials and induces the raising of prices of numerous goods competing with those import commodities that became dearer. Nevertheless, it should be stressed that local prices went up by more than can be attributed to the costlier imports; this was due to the prevailing overdemand, whose cumulative effect has grown from year to year. What is more, the price increases were no smaller for commodities and services which are not exposed to the competition of imports and where the import component is relatively low. This local inflation is reflected in the price rise of domestic resource uses, net of the increased cost of imports: in the first nine months of 1973 these ran 20 percent higher on an average than in the corresponding period the year before, after a 14 percent rise in 1972.

Another manifestation of the sharpening of inflation is the growth of the import surplus. The buoyant demand resulted in a much higher import bill, even though imports had become much dearer and exports made only sluggish headway. During the first three quarters of 1973 the import surplus reached \$ 1,300 million, compared with \$ 800 million in the same period the year before—an increase of more than 60 percent. Nearly half the increment can be ascribed to the advance in world prices, which hit the Israeli economy particularly hard, for even though import and export prices went up to about the same extent, this country imports nearly twice as much as it exports.

During the first three quarters of 1973 commodity imports shot up 60 percent above its level in the same period the year before; in real terms the rise was 30 percent. Service imports (excluding defense) went up 27 percent in nominal

and 13 percent in real terms. This much bigger import reflects the surging domestic demand, especially for durable consumer goods. After a small increase in overseas raw material purchases in 1972, when most of the requirements were met out of existing stocks, imports spurted in the first three quarters of 1973, even exceeding the level that might have been expected on the basis of input-output coefficients. In those branches where productive capacity was being fully utilized, the substitution of domestic for imported inputs might have been expected to be reflected in the output data, but so far it has found only partial expression.

Commodity exports gained 12 percent in real terms, with diamonds setting the pace. In those items which are produced for both the home and overseas markets, export growth slumped noticeably, continuing the previous year's trend. This was an outcome of several developments, the most important of which were the intensification of demand pressures in the economy, which heightened the competition between the domestic and export destinations; the higher production costs, which checked the growth of export profitability despite the devaluation of the Israeli pound; the rise in world market prices; and an increase in export incentives.

The marked widening of the import surplus during the first nine months of 1973 stands out against the stable inflow of capital, and it resulted in a gradual deterioration in the country's balance of payments position. Whereas in 1972 unilateral transfers fully covered the import surplus, in the first three quarters of 1973 they were more than \$ 500 million below the surplus. This was not fully reflected in the economy's net foreign liabilities, since the new liabilities were partly offset by \$ 76 million in net revaluation increments (the revaluation of the country's foreign exchange reserves, less the revaluation of foreign liabilities in dollar terms); the economy's net foreign liabilities therefore grew by only \$ 250 million.

As already mentioned, the excess demand began to build up in the second half of 1970, when the economy was approaching full employment. At the same time, there was a formidable increase in private sector transfers from abroad and in the surplus of the public sector's domestic expenditures over its domestic receipts. The relative importance of these two factors varied from time to time, but throughout the entire period until September 1973 they stimulated demand both directly and indirectly through the rapid monetary expansion that came in their wake. Nevertheless, despite the slackening of monetary expansion during the first nine months of 1973 compared with the same period the year before, according to both the narrow definition of money as demand deposits and currency and its broader definition, inflationary pressures mounted, as reflected by the spiralling of prices and the enormously greater import surplus.

The heightening of inflation in the first three quarters of 1973 was due, as already noted, to the protracted buildup of demand pressure. One of its main manifestations was the growth of private consumption per capita—9 percent

during the period discussed here, compared with 5.5 percent in 1972 and an average of only 1 percent in 1970–71. This development can be attributed to the decline in the rate of saving out of disposable private income. No satisfactory explanation can be offered for the reversal of the unbroken five-year uptrend in the rate of private saving in 1973. It may have represented the lagged adjustment of private consumption to the rapid growth of real disposable income in 1971–72.

Another plausible explanation is that the expectation of a continued rapid spurt in prices—which was strengthened by fears of a wide-ranging hike in taxes at the beginning of the new fiscal year in April 1973 and after the elections scheduled for October 1973—led to a heavy wave of consumer durables purchases in anticipation of a rise in their prices. The buildup of the public's liquid financial asset holdings in the last few years unquestionably facilitated the financing of such purchases.

In 1970–71 the Government adopted a tight fiscal policy, which caused disposable private income to trail behind the growth of gross income. By contrast, the easing of the restrictive fiscal policy in 1972 led to an opposite development—i.e. a faster rise in disposable income than in gross income. But in 1972 this policy change did not find full reflection in an increased private consumption because of the high rate of private saving. During the first three quarters of 1973, when again there was no restrictive fiscal policy, the drop in the rate of private saving, combined with the growth of disposable income, led to a more rapid increase in private consumption. The acceleration of this final demand in 1972 and the intensification of this trend during the first three quarters of 1973 thus accounted for most of the growth of domestic demand and of its weight in incremental uses.

The slowdown in monetary expansion during the first three quarters of 1973 compared with the same period the year before was not of such dimensions as to blunt the inflationary impact of the pent-up demand and of the strong upswing in private consumption. There were two reasons for this: (1) the slackening of the monetary expansion was not accompanied by a sufficiently comprehensive policy of incomes restraint; (2) as explained below, the contractionary effect of the slower monetary expansion was dulled by the excess liquidity prevailing at the end of 1972 and by the weakening of demand for money and other unlinked liquid assets.

The expansion of domestic demands did not display a uniform pattern: whereas purchases of consumer goods went up sharply, investment rose to only a mild extent: net of ships and aircraft, acquisitions of which quadrupled compared with 1972, the growth of nondwelling investment came to 10 percent. Although this was below the extraordinary 20 percent advance recorded the year before, it is by no means an insignificant rise, either in comparison with previous years or compared with what might have been expected in view of the 8–10 percent annual gain in the domestic product. The growth of investment

was particularly slack in industry, where it inched up by a mere 2 percent owing to a smaller rise in imported plant and equipment in branches registering rapid increases in 1972. On the other hand, there was a notable expansion of industrial construction starts. The value of new residential construction put in place continued upward, by a fairly vigorous 16 percent, but this was below the rate for the last few years, when demand for homes, for both immediate occupancy and for investment purposes, reached record heights. New home starts slumped noticeably in the third quarter of 1973, after the level had tapered off in the previous year.

The spurt in per capita private consumption, public civilian consumption, and public sector investment, the more sluggish advance in exports, the higher import bill, and the slackening of GNP growth accompanied by the full exploitation of all manpower reserves—all these resulted in structural changes in domestic resources and uses. The weight of imports in incremental uses went up and that of GNP declined. On the other hand, there were striking changes in the allocation of incremental resources. The weight of private consumption in incremental uses (excluding ships and aircraft and defense imports) moved up steadily from 19 percent in 1971 to 36 percent in 1972 and 43 percent in the first three quarters of 1973. The share of exports, on the other hand, dropped during this period from 42 percent to 28 and 21 percent respectively.

The more sluggish growth of the gross national product did not lead to any easing of demand pressure in the labor market; the smaller percentage increase in the labor input was due less to a weakening of demand than to the fact that the supply of Israeli labor was fully tapped, as evidenced by the drop in the rate of unemployed job-seekers to its lowest level ever (2.4 percent) and a rise in the proportion of part-time workers. Employment was up 4.9 percent in the first nine months of 1973, after advancing 6.6 percent in the same period the year before. This increase can only be partly attributed to the 3.3 percent expansion of the working-age population; in the main it reflects a decline in the number of unemployed seeking work and a 24 percent rise in the number of persons from the administered areas working in Israel. The increase in labor from the administered areas was accompanied by a drop in employment in the areas themselves and the steep hiking of wages there. As opposed to these developments, which operated to enlarge the labor supply, the 2 percent decline in the average number of man-hours worked per employed had an opposite effect. The decrease in the number of man-hours worked per employed did not embrace full-time workers, but was due solely to a rise in the percentage of part-time labor in total employed.

Although the various labor demand and supply indicators reveal intersectoral divergences, it seems that the dominant feature in the period reviewed was at least a continuation, if not some sharpening, of pressure in the labor market. This pushed up earnings per employee by 25 percent, after a 15 percent advance the year before, making a total rise of 45 percent over the past two years for

those for whom biennial wage agreements were concluded. This is a steep rise, but given the jump in the general price level, the growth of GNP per employed, and the lowest level of unemployment to be recorded in the past few years, such a development was not unexpected.

The retardation of monetary expansion, which began in the second half of 1972 with the deceleration of foreign currency accumulation and with the absorptive measures introduced by the Government and the Bank of Israel, was reflected in the first quarter of 1973 by a contraction of the money base and the arresting of the upward trend in the money supply and other unlinked liquid assets—time deposits and the Short-Term Loan. But at the beginning of the 1973–74 fiscal year the Government resumed its substantial infusion of liquidity. Despite the sharp downswing in the liquidity injection due to foreign currency conversions by the private sector in the wake of the greatly increased import surplus, the rapid monetary expansion reasserted itself, and from April through September the money supply went up by a seasonally adjusted average of some 3 percent a month.

During the first three quarters of 1973 the money base expanded by 16 percent, compared with 27 percent in the same period the year before. The money supply went up by 20 and 23 percent respectively, while unlinked interest-bearing assets (IL time deposits and the Short-Term Loan) did not grow at all, after advancing 19 percent in 1972. The slower growth of the money base, combined with the buoyant demand for credit, resulted in a tight money market, reflected by the running of large liquidity deficits by the banks, a slight rise in the rate of debitory interest (mainly on marginal credits), and an attempt by the banks to prevent the expansion of credit through more stringent rationing. But these developments failed to effectively check the mounting demand pressure for three reasons: (1) The aggravation of inflation dampened the demand for holding unlinked liquid assets—principally time deposits and the Short-Term Loan and to a lesser extent demand deposits. (2) The rapid monetary expansion in 1971 and the first half of 1972 was not completely offset by the sharp rise in prices in those years and the increase in the import surplus, with the consequence that considerable excess liquidity accumulated, which was partly diverted to the real estate and share markets. There are indications that some of the liquid assets held for financing transactions in these markets helped permit the expansion of demand in the commodity and service markets in 1973. (3) There is reason to believe that in 1973 part of the investing public changed their attitude toward index-linked bonds, and these became more a near substitute for liquid assets than merely a medium-term savings instrument, as in the past. This reshuffling of the public's asset portfolio was connected with the marked aggravation of the inflation since the fourth quarter of 1972, which drove up the nominal rate of return on bonds while diminishing the risk involved in holding this type of paper for short periods. As a result, since 1973

(particularly the immediate postwar period) the money supply and unlinked assets do not fully mirror the growth of the economy's liquidity.

Bank credit to the public, like the other monetary variables, developed differently in the first quarter of 1973 and in the months of April-September. In the first quarter of the year, which was the last quarter of fiscal 1972/73, the large-scale absorption of liquidity by the Government was accompanied by a marked growth in undirected credit from the banks' free resources. Between April and September the expansion of credit was at first rather slow, but when growth began to pick up, the Bank of Israel in July 1973 slapped a 100 percent liquidity ratio on incremental credit of this type. Altogether, nondirected credit went up by 16 percent, as against 10 percent in 1972. The faster increase was chiefly connected with the shrinkage of liquidity due to the conversion of foreign currency. But this growth rate is not high compared with the expansion of economic activity and the increase in production and prices, and it seems that the brisker demand for such credit was partly checked by its tighter rationing by the banks and the appreciably larger volume of short-term directed credit granted.

The slower rate of monetary expansion in the first three quarters of 1973 is explained by the reduced foreign currency conversion by the private sector, while the public sector, after soaking up liquidity in the first nine months of 1972, did not absorb any liquidity at all during the same months in 1973. During this period the Bank of Israel drained off liquidity, in continuation of its absorptive policy of the last few years. Nevertheless, the amount of money siphoned off in the first three quarters of 1973 was far less than in the corresponding period the year before, owing to the sharply fluctuating movement of the monetary variables during the year: a sharp decline in the money base in the first quarter of 1973 resulted in the incurring of unprecedented liquidity deficits and blunted the effectiveness of the absorptive measures taken immediately upon the resumption of a substantial liquidity injection in the second quarter of the year.

For lack of detailed data on the Government's financial transactions between April and December 1973, the effect of the Government's operations on aggregate demand could not be measured through its demand surplus, but only by one comprehensive indicator—the injection of liquidity as narrowly defined (its influence on the money base). The change in the public's attitude toward index-linked bonds points up the deficiencies of this indicator, and it is doubtful whether all the Government's receipts from bond sales to the public can be treated as a liquidity absorption, since as against the funds so mobilized the public had large holdings of assets whose liquidity was high in the prevailing circumstances.

The Government continued to mop up liquidity during most of fiscal 1972/73, with the amount increasing at the close of the year. In April 1973, the start of the new fiscal year, the Government resumed its infusion of liquidity, and

in the first half of 1973/74 the public sector as a whole pumped a total of IL 650 million into the economy. Thus, this sector contributed to the rapid expansion of the money base, along with the reduced contribution of the private sector through foreign currency conversions.

Public consumption rose 18 percent in current prices in the first nine months of 1973 compared with the same period in the previous year. At constant prices, the level crept up by less than 0.5 percent, after inching down 2 percent in 1972. Noncivilian public consumption fell off during this period by 4.5 percent in constant prices, with both domestic spending and defense imports sharing in the decline. Civilian public consumption spending was up 9.5 percent in constant prices during the first three quarters of 1973.

Public sector investment during the period reviewed soared 46 percent in current and 17 percent in constant prices. In social and municipal services the level went up at a below-average rate, and in economic services (through the Government's business-type enterprises and local authorities) at a faster-than-average rate.

After a rather laggard growth in 1972 (because of arrears in collections and the reduction of rates), income tax revenue in the year reviewed outpaced the rise in gross private income from economic activity, despite the further paring of rates; this was mainly due to collections on account of earlier years.

The stronger upswing in income tax revenue was partly offset by a much heavier volume of transfer payments in 1973. Total revenue from direct taxes and compulsory loans, less transfer payments, went up 27 percent, compared with a 31 percent gain in private income. This contrasts with the situation in 1972, when direct tax revenue and compulsory loan receipts moved up only 6 percent, while private income rose 26 percent. But during the first three quarters of 1973 the amount of liquidity siphoned off by the public sector lagged behind the growth of revenue, so that the Government's fiscal policy failed to check the rise in disposable private income. By contrast, in 1970-71 the Government had adopted a policy of incomes restraint, hiking taxes and levying compulsory loans, with the result that in these two years the growth of disposable private income trailed behind that of private income.

Indirect revenue (less the war levy on defense imports) showed a different development in the year reviewed. During the first nine months collections ran at a slower pace than private income. Disregarding export incentives—which were upped in January and August—and the subsidization of certain locally produced and imported items in order to keep their prices down in the face of the higher prices charged abroad for raw materials for the food industry, the growth of net indirect tax revenue was even more sluggish, in relation to both GNP and the volume of such receipts in the previous year.

Total public sector revenue from taxes and compulsory loans jumped 30 percent during the first three quarters of 1973, as opposed to 24 percent the year before. Less transfer payments and subsidies, the net amount of liquidity

absorbed by the public sector increased 24 percent during the first nine months of 1973, compared with 22 percent in 1972.

After the outbreak of war the level of economic activity dropped off, with the decline being sharpest during and immediately after the fighting. Following the partial demobilization of manpower and equipment and the adjustment of the economy to the new situation, business gradually picked up, but by the end of December both employment and economic activity were still well below their prewar level.

The main reason for the slackening of activity was the detrimental effect which the mobilization of manpower and equipment had on productive capacity; a secondary factor was the change in the pattern of domestic demands: heavier purchases of the products of several sectors and branches and a decline in others. In general, no serious disruptions cropped up in the economy, although bottlenecks did appear in several areas. The percentage of civilian road haulage capacity mobilized was several times higher than the proportion of manpower called up, and the mobilization of key men sometimes hampered the operation of plants by those who were not called up; moreover, during and immediately after the fighting residents of the administered areas did not turn up to work in Israel to the same extent as before.

Nevertheless, fourth-quarter estimates indicate that the contraction of the gross domestic product of the private economy was no greater than expected in view of the extensive mobilization of manpower, and may even have been lower. These findings are consistent with partial evidence suggesting that some enterprises succeeded in mitigating the disruption of production due to the mobilization by making a more strenuous effort and working longer hours. Construction and industry were affected more than services and agriculture, since the percentage of males of military age is higher in these sectors and their transport requirements are greater.

The pattern of demand, as already mentioned, altered after the fighting: the war atmosphere, the high tension, and the general call-up depressed private consumption and home sales; those called up for active service suffered a drop in earnings, the income of companies and self-employed was also hit, and in general there was a fall in spendable private income. Investment projects in various stages of implementation, including housing construction, were slowed down because of the shortage of manpower and other factors of production, while new investment plans were shelved also because of the uncertain business outlook. Commodity exports were hampered by the disruption of production and transportation. As opposed to the faltering of civilian demand, the Defense Ministry stepped up its purchases of domestic manufactures. Initially some of the new procurement orders were supplied from existing civilian stocks, but eventually they began to influence current economic activity. Public consumption spending in the final quarter of 1973 surpassed the level in the rest of the

year, and the public sector injected more liquidity into the economy during these three months.

To finance the enormously heavier noncivilian expenditures in as noninflationary a manner as possible, at a time when the economy's productive capacity was affected by the mobilization, the Government took action to dampen real disposable income: it levied compulsory loans with a view to reducing private consumption, imposed new indirect taxes, and trimmed subsidies. The specific measures introduced were as follows: (1) the issue of a 15-year compulsory nonnegotiable loan, levied on taxable income at the rate of 7-12 percent, and a publicity campaign to plug a voluntary War Loan; (2) the upping of the defense levy on imports by 5 percentage points; (3) the hiking of the purchase tax by 5 percent; (4) the further raising of customs duties and purchase tax rates by up to 20 percent, in the main on luxury goods; (5) two rounds of subsidy cuts on basic foodstuffs (in November and January); and (6) the raising of fuel and electricity prices (in October and January).

These fiscal measures, designed to mop up purchasing power from the public, were only partially reflected in the fourth-quarter data, since some IL 800 million was injected into the economy during this period. To some extent, this infusion was deliberate, intended to help bring economic activity back to normal; at the same time it blunted the influence of the nongovernmental sectors' contribution to the absorption of liquidity through their large-scale conversion of foreign currency.

Since the war no shortage of liquidity has been felt, thanks to the policy of supplying the liquidity needed for restoring normal economic activity. But there have been sharp swings in the component liquid assets. In October and November the money supply swelled, and since December holdings of assets linked to the cost-of-living index or the exchange rate have contracted.

In October there was a brisk demand for liquidity on the part of the public, as had happened in previous war periods; this was reflected primarily by a big increase in currency in circulation and demand deposits. In this month the Treasury and the Bank of Israel already took measures to pump liquidity into the economy in order to prevent the interruption of economic activity because of a shortage of financing.

It should be noted that when war broke out the banks were running large liquidity deficits. There was therefore reason to believe that the increased withdrawal of cash would lead to a reduction of credit to the public and that not all the credit demand could be met, so that economic activity would be unduly affected. In October the Bank of Israel released the commercial banks from their obligation to purchase a certain amount of Short-Term Loan certificates each week under the underwriting agreement; as a result, the balance of this loan started to plunge at a weekly rate of some IL 30 million. The Bank of Israel also gave a standby rediscount facility to the commercial banks (until the end of November), to export industries in order to help them finance the

shipment of goods that had been held up, and to industry and agriculture in order to prevent the disruption of activity; it also made a special facility available to agriculture in the form of credit from funds exempted from the liquidity requirements, in order to tide the sector over during the emergency period.

In the final quarter of 1973 the price level moved up faster than in the preceding three quarters. In December the consumer price index (seasonally adjusted) stood 7.5 percent higher than in September, whereas the average quarterly rise during the first nine months was 5.5 percent. But in contrast to the rise in the first three quarters of the year, which was due mainly to demand-pull, the fourth-quarter increase was more a result of cost-push. The jump in costs during this period was due chiefly to international developments and to the various policy measures outlined above. But the possibility cannot be ruled out that part of the rise was a lagged response to the prewar monetary expansion and the appreciable liquidity infusion during and immediately after the fighting.

As regards the balance of payments, in the final quarter of the year the current deficit grew as much as in the preceding nine months. Noncivilian imports soared, but this was partly offset by a sharp drop in civilian imports and exports, which were chiefly affected by factors connected with the war effort and whose net effect was to reduce the deficit. Capital imports went up slightly faster than the current deficit, and unilateral transfers exceeded the deficit after nearly doubling in volume. Personal transfers and investment contracted noticeably, but public sector capital imports rose steeply, reflecting the intensified effort to mobilize funds from among world Jewry and its willingness to respond to the appeal, as well as the large loans received from the U.S. Government.

Commodity exports fell 17 percent in real terms below the third-quarter level. The biggest drop was in diamonds—down 38 percent. This setback is explained not only by the war but also by the worldwide slump in diamonds. In other industrial exports there was a gradual recovery and elimination of the backlog of earlier months. Commodity imports (excluding ships and aircraft) were down 27 percent in real terms from the previous quarter. There was a sharp decline in October, but toward the end of 1973 and the beginning of 1974 the figure regained its high prewar level. Service imports (excluding defense items and imports from the administered areas) were off mainly in the foreign travel item, due to the smaller number of Israelis going abroad during the last three months of the year because of the war and the protracted mobilization.

In service exports there was a drop in transportation, communications, and tourism. Despite a fourth-quarter improvement in the balance of payments, the economy's foreign exchange reserves expanded by a relatively small \$ 215 million during 1973. The country's net foreign liabilities increased by \$ 135 million, owing to the decline of several European currencies against the dollar.

Since the war economic policy has aimed at preventing the interruption of civilian economic activity—initially by utilizing to the fullest possible extent the manpower, equipment, and vehicles which were not mobilized; and subsequently, with their gradual demobilization, by reabsorbing the manpower and vehicles. These objectives have been attained with a large degree of success, and in the first part of 1974 the economy quickly regained its vigorous prewar level.

Exports and imports have surpassed their prewar levels, employment and output in industry are also rebounding, and in construction, agriculture, and services employment has likewise returned to its level before October. Various indicators point to a strong recovery of both nondwelling and dwelling investment. The taxes that were imposed with a view to dampening private consumption and thereby release domestic resources for defense production have staved off the resumption of inflationary pressures, a further deterioration in the balance of payments, and a dwindling of the economy's foreign exchange reserves. But the demand pressures which prevailed during the first nine months of the year have reappeared, fueled by an additional source—heavier noncivilian demand. The economy must therefore contend once again with the problem of inflation, for if the demand pressures are not checked, the advance of prices will reach unprecedented proportions.

But the foremost problem facing the economy is the widening gap between imports and exports. To some extent this is an outcome of the inevitable growth of noncivilian imports and the rise in fuel, food, and raw material prices on the world markets, whose effect on the import surplus is not being offset by a corresponding expansion of exports. The anticipated deterioration in the balance of payments can also be ascribed to the surging demand under conditions of full and even overemployment, which not only pushes up prices but also induces a heavier import, diminishes export profitability, and leads to the diversion of locally produced goods from the export to the home market. Any delay in introducing measures to check inflation and reduce the balance of payments deficit will only intensify the negative trends which prevailed during the first nine months of the year—a rapid growth of private income, per capita private consumption, and imports; the favoring of the domestic over the foreign market; and ultimately a sizable increase in the balance of payments deficit of such dimensions that its short-term financing will necessitate the drawing down of the country's foreign currency balances or a rise in its external debt—developments which the economy will find it hard to stand up to in the long run. A prime factor in the success of economic policy is how quickly remedial action is taken; the longer it is put off, the more far-ranging and stringent it will have to be in the future.