CHAPTER III

THE BALANCE OF PAYMENTS – GENERAL SURVEY

1. Main Developments

The balance of payments deficit on current account rose in 1978 from $2,550 million to $3,400 million. Most of the increase was due to a $500 million larger defense import bill. The civilian deficit, excluding trade with the administered areas, was up $200 million in current prices, but remained unchanged in constant price terms. The sharp contraction of rough diamond imports shaved $200 million off the deficit.

The current account trends, exclusive of diamonds, reflected the resumption of economic growth, fueled by a stronger domestic demand. Admittedly, the rebounding of economic activity was quite modest considering the protracted stagnation and consequent underutilization of productive capacity. The livelier domestic demand, however, caused the export advance to falter noticeably. In commodities the gain declined from 15 to 9 percent, and in exports of industrial goods with a domestic market the slowdown was sharper yet.

In nondiamond commodity imports the uptrend accelerated from 2 to 12 percent. This increase, which occurred concurrently with a steep jump in the relative price of imports compared with the implicit product deflator, encompassed nearly all groups, and reflected the rising weight of uses with a high import content – notably investment goods, inventory accumulation, and durable consumer goods – as the economy resumed its growth.

The faster expansion of imports in 1978 and the more laggard expansion of exports carried over into the first quarter of 1979, as evidenced by an appreciable widening of the trade deficit, which stood 50 percent above its average level in 1978.

In the capital account there was a much larger inflow of funds from several sources. U.S. government aid rose $600 million with the expansion of defense imports, and accounted for nearly 80 percent of the public sector's total capital import. There was also a steep rise in remittances by private individuals and immigrants ($100 million) and in investment capital ($80 million). This must be viewed against the change in economic trends, and especially the striking change in the relative rates of return on various assets and the consequent reshuffling of the public's asset portfolio.

TABLE III-1

CURRENT ACCOUNT, 1971–1978
($ million)

	Imports					Exports			Deficit					
	Goods	Services	Goods & services	Defense imports	Total incl. defense imports	Goods	Services	Goods & services	Trade balance	Services	Total	Total incl. defense imports	Current account with admin. areas	Total current deficit
A. At current prices														
1971	1,758	767	2,525	555	3,080	900	914	1,814	–858	147	–711	–1,266	40	–1,226
1972	1,900	871	2,771	490	3,261	1,082	1,047	2,128	–818	176	–642	–1,132	31	–1,101
1973[a]	2,896	1,189	4,085	1,253	5,338	1,366	1,317	2,683	–1,530	128	1,402	–2,655	32	–2,623
1973	2,930	1,153	4,083	471	4,554	1,422	1,310	2,732	–1,508	157	–1,351	–1,822	28	–1,794
1974	4,073	1,614	5,687	1,224	6,911	1,706	1,819	3,525	–2,367	205	–2,162	–3,386	62	–3,324
1975	4,006	1,853	5,859	1,846	7,705	1,811	1,783	3,594	–2,195	–70	–2,265	–4,111	97	–4,014
1976	3,981	2,066	3,047	1,561	7,608	2,277	1,993	4,270	–1,704	–73	–1,777	–3,338	137	–3,201
1977	4,654	2,332	6,986	1,099	8,085	2,937	2,386	5,323	–1,717	54	–1,663	–2,762	204	–2,558
1978	5,541	2,764	8,305	1,624	9,929	3,680	2,735	6,415	–1,861	–29	–1,890	–3,514	106	–3,408
B. At 1977 prices														
1971	3,604	1,341	4,945	882	5,827	1,726	1,543	3,629	–1,878	202	–1,676	–2,558		
1972	3,655	1,463	5,118	740	5,858	1,959	1,728	3,687	–1,696	265	–1,431	–2,171		
1973	4,360	1,737	6,097	1,705	7,802	2,027	1,922	3,950	–2,332	185	–2,147	–3,852		
1974	4,475	1,979	6,454	1,477	7,931	2,116	2,114	4,230	–2,359	135	–1,224	–3,701		
1975	4,215	2,118	6,333	2,032	8,365	2,134	2,030	4,164	–2,081	–88	–2,169	–4,201		
1976	4,315	2,224	6,539	1,659	8,198	2,634	2,163	4,797	–1,681	–61	–1,742	–3,401		
1977	4,654	2,332	6,986	1,099	8,085	2,937	2,386	5,323	–1,717	54	–1,663	–2,762		
1978	4,778	2,609	7,387	1,542	8,929	2,832	2,752	5,684	–1,846	143	–1,703	–3,245		

C. Index of quantitative growth

(1972 = 100)

1971	98	92	96	119	100	89	89	64	111	78	120	119
1972	100	100	100	100	100	100	100	100	100	100	100	100
1973	119	119	119	230	135	103	111	107	141	74	159	190
1973	127	120	124	89	119	109	116	112	150	81	165	135
1974	122	135	119	200	137	109	122	115	140	58	160	179
1975	115	145	125	275	146	110	117	114	122		158	210
1976	117	152	128	224	143	136	125	130	92		120	165
1977	126	159	136	149	138	151	138	145	92		109	126
1978	127	178	143	208	153	149	159	154	99			

D. Prices indexes

(1972 = 100)

1971	90	96	95	95	95	93	98	95
1972	100	100	100	100	100	100	100	100
1973	128	115	124	111	121	123	113	118
1974	175	137	163	125	155	145	142	143
1975	183	147	171	137	161	152	145	149
1976	179	156	170	142	163	155	152	154
1977	195	168	185	151	180	180	165	173
1978	229	178	209	159	199	229	164	196

[a] First three quarters at annual rates.

SOURCE: Central Bureau of Statistics.

The boom in the domestic assets markets, sparked by the portfolio adjustments and the liberalization of foreign currency control, led to a bigger private sector import of capital, particularly short-term. The increased profitability of domestic assets in the wake of the boom and the higher relative price of domestic credit due to the policy of monetary restraint were reflected by a greater flow of money from abroad, and in the summer of 1978 resulted in a laggard adjustment of the exchange rate; this in turn made it even more worthwhile to borrow abroad. This, of course, had a destabilizing effect, which found expression, *inter alia,* in the mobilization of a sizable amount of foreign credit by commercial banks. In the final quarter of the year their net liabilities to the foreign sector swelled by $450 million.

The slackening of export growth in 1978 points up the dominant influence of domestic demand on the development of overseas sales. In contrast to the factors which stimulated exports in the previous period of vigorous expansion (1968–71), in recent years the improvement in export profitability has been more limited. The headway made in such sales can be credited mainly to the curbing of domestic demand, and partly to the investments made in export industries. In the prevailing conditions, and especially in the absence of unemployment, the profitability of exports did not reach a level that would permit the diversion of more unutilized productive factors to this use and enable it to compete more effectively for potential factors. Consequently, the renewed expansion of domestic demand was inevitably at the expense of exports by industries producing also for the home market. To prevent a standstill and even a downturn in exports will necessitate, in addition to the bridling of domestic demand, a greater effort to effect a real improvement in their profitability, which throughout the recent period of stagnation fell short of what was required.

The balance of payments continues to be the core of the problem confronting the economy. The restraining of economic activity was necessary for bringing about the structural changes required after the 1973 balance of payments crisis. But in 1974–77 the damping of economic activity and flattening of growth did not result in the restructuring of the economy to a sufficient degree. The paring of the deficit was achieved at the expense of zero growth and a drastic cutback in investment, and the modest upswing in domestic demand in 1978 was accompanied by the escalation of inflation and a marked slowdown in exports. The economy has apparently not yet reached a point from which it can resume a vigorous growth path such as that which existed up to 1973. It seems more and more that what began as a temporary cooling of economic activity is liable to develop into a fundamental turning-point in the trend of the economy – to one of sluggish growth and a much milder rise in the standard of living in the long run.

2. The Current Account

The deficit on goods and services rose from \$ 2,560 million in 1957 to \$ 3,450 million at current prices. Most of the increase—\$ 500 million— was due to a much higher defense import bill. Excluding defense and trade with the administered areas, the deficit grew by \$ 200 million at current prices. At 1977 prices it held virtually steady at \$ 1,700 million.

The trade deficit (excluding diamonds) widened by \$ 250 million, or 14 percent, at 1977 prices. This was the net result of a slackening of the commodity export advance from 15 to 9 percent[1] and an acceleration of import growth from 2 to 11 percent. Commodity export prices went up faster than import prices, improving Israel's terms of trade by 4 percent.[2] This can be credited to the nonincrease in oil prices in 1978 (which are now moving up rapidly) and the comparatively small price rise in raw materials and finished goods (which account for a substantial part of Israel's imports).

Overseas sales of polished diamonds shaved \$ 200 million off the deficit (at current prices). At the beginning of the year the speculative stockpiling of rough diamonds which went on in 1977 ceased, and this was reflected by a sharp contraction of current imports, even in relation to exports (which also slowed this year, although more moderately).

In the services account there was a \$ 100 million improvement in constant price terms and a \$ 100 million deterioration in current prices. The trend here was thus the opposite of that in the trade deficit: a worsening of the country's terms of trade following the stabilization of export prices and a 6 percent increase in import prices.[3]

Service imports were up 19 percent in current price terms, compared with 15 percent in service exports. Quantitywise, exports expanded faster than imports, but the advance was largely accounted for by capital services and insurance (items which showed a similar rapid increase on the import side). In exports the most striking feature was a niggardly 4 percent gain (at current prices) in tourist services, as opposed to a 43 percent increase in imports of such services.

The rate of the devaluation for services under the October 1977 foreign currency reform was far greater than that for commodities. Apart from the export of knowhow and hotel tourist services, which enjoyed an incentive before the reform and for which the

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1 All growth rates cited here are in quantity terms unless otherwise stated.

2 This improvement was not reflected by a slower growth of the deficit in current prices compared with that in constant prices because of the large weight of imports relative to exports.

3 The price indexes for services are of limited reliability and hence should be regarded with reservation.

TABLE III-2

INDICATORS OF EXPORT PROFITABILITY, 1966–1978

	Price of industrial export value added/unit wage costs[a] (1)	Industrial export proceeds[b]/total costs[a] (2)	Industrial export proceeds/domestic market returns (3)	Industrial domestic market returns/total costs[c] (4)	Price of value added ratio: export goods[d]/non-tradable goods (5)
1966	68.3	79.4	74.3	106.9	
1970					100.0
1971					99.5
1972	100.0	100.0	100.0	100.0	93.9
1973	108.0	104.3	106.2	98.2	83.2
1974	109.3	100.6	105.6	95.3	80.8
1975	119.0	104.9	112.2	93.5	88.2
1976	114.9	104.0	113.4	91.7	91.0
1977	113.8	106.9	120.9	88.4	95.9
1978	114.8	110.6	129.1	85.7	97.7

[a] The Central Bureau of Statistics compiles two separate series on industrial labor costs, which give a desparate picture of developments in this sphere: the nominal daily wage index and the index of total wages of industrial workers. The main difference between them is that retroactive and one-time payments are included in the former but not in the latter measure. The indexes in columns (1) and (2) are based on the first series. The corresponding column (1), which is based on the second series gives 113.3 for 1975, compared to 119.0 in column (1), while for 1978, it gives 104.6. The alternative calculation for column (2), which also includes the index of depreciation expenses for purchased inputs, gives 106.2 for 1978, in contrast to 110.6 in column (2).

[b] The combined foreign price and exchange rate effects.

[c] Column (2) divided by column (3).

[d] Excluding diamonds.

rate of effective devaluation was 16–17 percent,[4] the exchange rate for service exports and imports increased by 44 percent. The implications of this for the services account are, however, a complex matter. First of all, a substantial part of the trade in invisibles (30 percent of the exports and 50 percent of the imports) is in capital services and insurance, and in these items a devaluation does not affect the relative price and hence the behavior of economic units. Another relatively large part consists of items with a very low price elasticity, and their magnitude is chiefly a function of the level of economic activity (e.g. import cargo transport, foreign currency outlays of shipping and aviation companies, and various components of the "other services" item). For this reason, a devaluation apparently has a relatively limited impact on trade in invisibles.

Commodity imports (other than diamonds) underwent a change of trend as the economy moved into higher gear after virtual stagnation in 1977 (a growth of 2 percent following two years of decline). All told, the level moved up 12 percent, with increases being recorded in almost all categories. The rise in imports outstripped that in the product and uses, bringing up their weight in total uses; at the same time there was a precipitate jump in the price of imports relative to GNP (see Table IV-2).[5] This would seem to indicate, above all, a rise in the weight of import-intensive uses with the expansion of economic activity. This applies in particular to capital goods (machinery, equipment, and trucks), stocks of inputs, and consumer durables. The buildup of inventories is typical of a shift to a higher level of activity, and constitutes part of the process of adjusting to the new conditions.

The sharpest rise was recorded in capital goods. This reversed a three-year downturn, but the 1978 level was still 9 percent below that of 1974. In this connection it is important to note that the volume of discards has been increasing steadily;[6] hence investment on a scale similar to that in 1974 implies a much smaller net growth of the capital stock.[7] What caused the larger import of capital goods (and the expansion of

4 See the Bank of Israel Annual Report for 1977, Table V-13.

5 Caution must be exercised in making such comparisons in a period of high inflation, when the adjustment of prices does not proceed at an even pace in the various sectors of the economy. In addition, import and export prices moved up at greatly disparate rates, with the former rising steeply immediately after the foreign currency reform but more slowly thereafter.

6 The estimation of discards is based on the assumption of a constant rate, and there may have been some changes in this respect because of the economic slowdown.

7 Assuming that the rate of discards for the stock of imported capital equipment is equal to that for the average capital stock in the economy (an unreasonable assumption, considering that the rate of discards for buildings is much smaller), then the import of capital goods in 1978 implies a net capital stock increment 23 percent smaller than in 1974.

TABLE

CURRENT DEFICIT AND THE

($ million,

		Current deficit	Thereof: defense imports	Long-term capital: Uni-lateral transfers	Long-term capital: Long-term loans	Long-term capital: Foreign investments	Long-term capital: Total	Surplus or deficit (–) of long-term capital over the current deficit
1972		–1,114	–490	1,051	588	148	1,787	673
1973		–2,615	–1,253	2,173	832	185	3,190	575
1974		–3,319	–1,225	1,708	541	97	2,356	–963
1975		–4,016	–1,846	1,772	1,476	68	3,316	–700
1976		–3,200	–1,603	2,210	1,015	58	3,283	83
1977		–2,563	–1,099	2,082	541	100	2,724	161
1978		–3,400	–1,612	2,429	1,035	182	3,646	246
1976	I	–728	–364	510	189	8	107	–21
	II	–870	–386	940	188	18	696	–174
	III	–741	–373	66	187	17	865	124
	IV	–872	–480	562	438	15	1,015	143
1977	I	–502	–229	423	165	22	619	117
	II	–703	–306	475	111	22	608	–95
	III	–733	–225	491	49	17	557	–176
	IV	–625	–625	684	216	39	939	314
1978	I	–868	–470	555	274	31	860	–8
	II	–838	–371	585	277	35	897	59
	III	–1,064	–497	633	167	53	853	–211
	IV	–630	–274	656	318	63	1,037	407

NOTE: A positive value indicates an increase in the case of liabilities, and a minus sign indicates an increase in the case of assets.
SOURCE: Central Bureau of Statistics.

III-3

CAPITAL ACCOUNT, 1972–1978
at current prices)

	Short-term financing sources							
	Credit to non-financial sectors							
IMF cred-it	Private sector	Government sector	Liquid foreign obligations of Israeli banks	Total short-term credit	Foreign currency reserves	Net use of short-term capital	Other items	Errors & omissions
–33	1	–37	–93	–129	–502	–631	–55	37
	–6	23	211	228	–522	–294	–266	–32
39	35	59	462	556	776	1,332	–80	–322
215	230	–70	528	688	–68	620	–80	–52
89	153	78	103	334	–124	210	–240	–142
	21	–24	–18	–21	–238	–259	–168	266
–14	66	–49	564	536	–866	–330	–226	326
	–25	25	–120	–120	59	–61	75	7
	140	16	37	193	–64	129	–61	106
75	–15	53	45	83	–72	11	–100	–110
14	53	–16	141	178	–47	131	–154	–164
	–58	3	–54	–109	–142	–251	6	128
	70	9	6	85	–26	59	143	–107
	–4	22	31	49	–6	43	28	105
	–13	–58	–1	–46	–64	–110	–345	141
–33	52	–13	–70	–31	–166	–197	119	119
–28	12	–66	138	84	23	107	–52	–86
60	29	–7	50	72	–55	17	–59	193
–23	–27	–8	445	410	–660	–259	–235	110

investment in general) is a crucial point in assessing balance of payments trends. This is because the available data seem to indicate the existence of spare capacity. One possible factor was the swelling of the subsidy element in investment finance with the escalation of inflation. A question of considerable importance for future balance of payments developments is to what extent will the resumption of economic growth be accompanied by a greater capital spending, and to what extent can the possible existence of unutilized capital moderate the growth of investment in the next stage. When the conomy is pulling out of a slump, an upswing in investment is usually one of the factors determining the pace of recovery.

The noticeable slackening of exports, which was reflected in some industries by an absolute decline and in most of the others (except defense goods) by the tailing off of growth, should be viewed against the change in the economic scene: the shift from restraint to the expansion of domestic demands. The export advance almost ground to a halt in all industries which have a domestic market (in the conventional sense of the term), with the exception of chemicals. Another conspicuous exception was the manufacture of defense goods, which, besides being different from the aspect of the basic factors influencing it, did not experience any increase in domestic demand this year.

In the slowing of export growth the expansion of domestic demands played the same predominant role as did the bridling of demands in stimulating exports in 1976–77. In these years (in fact during the entire period from 1973) there was no striking change in export profitability, in contrast to the previous period of vigorous export growth (1967–71). The dominant factor in the expansion of overseas sales was the curbing of domestic demands.

An analysis of export profitability is more complex this year than in the past, partly because of the problematic nature of the data.[8] Contrary to what the trends in economic activity might lead one to expect, there is no evidence of any serious deterioration in profitability in the short run. Some indicators point to an improvement, a few even to a marked improvement, despite the recovery of economic activity.

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[8] One problem arises from the existence of two wages series for industry: the nominal daily wage index and the index of total wages of industrial workers, with the main difference between them being that retroactive and one-time payments are included in the latter but not in the former measure. The latter series is consistently higher, and while the divergence between the two fluctuates, it has been growing steadily. Between 1972 and 1978 it amounted to a total of 11 percent. The second series seems preferable because it is more inclusive. Although the one-time payments undoubtedly distort a comparison between adjacent periods, notably in the case of intrayear quarterly date, they appear to be less weighty in long-term comparisons.

The apparent contradiction between the profitability picture and the actual export performance may reflect, apart from the domestic demand effects, exporters' profitability expectations which were not realized.

The most reliable indicator of the long-run profitability trend is probably the ratio between the exchange rate for export value added and labor costs per unit of output[9] (see Table II-2, col. 1). The exporting sector cannot be expected to expand and its demand for labor grow without ensuring a change in this ratio. In the short run export proceeds[10] relative to costs (col. 2) may increase even without an increase in the ratio between export proceeds and unit wage costs. This is what actually happened in recent years: between 1975 and 1978 the wage costs-export proceeds ratio rose, while the ratio between total costs and export proceeds declined. This indicates that profitability was hurt more the greater the wage component in total costs.

These mixed trends are explained by the relative drop in the prices of the other cost components, notably purchased domestic inputs. This decline mainly reflects the dent in profits from domestic marketing, a typical feature of a period of economic retrenchment accompanied by cost-inflation, when producers are unable to fully adjust their prices to the mounting costs (one indication of the contraction of profits can be seen in col. 4 of Table III-2).

The return on industrial exports relative to that from domestic marketing (Table III-2, col. 3) indicates the conditions which affect producers' decisions regarding direct substitution between foreign and domestic marketing. The rise in the relative return to exports by and large reflected the economic slowdown, which squeezed profits on local sales. This indicator, however, has only limited significance regarding the market structure in Israel, in which changes in domestic demands have a great impact, particularly in the short run.

The profitability trend and growth of exports should also be scrutinized in a broader perspective. Comparisons of this sort, however, are inherently more problematic the longer the period in question, and so they call for caution.

Overseas industrial sales[11] moved ahead at a 21 percent average annual rate in 1968–71. During this period Israel's share of the export markets grew by a total of 50 percent (see Table III-4), and sales to the home market at a 16 percent annual rate. In the last

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[9] Actually account should also be taken of the rise in export prices abroad, and so the comparison is not with the exchange rate but with the "price" per unit of export value added.

[10] The reference is to the combined foreign price and exchange rate effects.

[11] Apart from diamonds, minerals, and refined petroleum products.

four years (1975–78), a period of economic retrenchment in which there was a mere 3.7 percent gain in domestic marketing, industrial exports forged ahead at a 13.7 percent annual rate and Israel's share in the export markets rose by a total of 36 percent.

A striking concomitant of the differential rate of growth in these two periods can be seen in the development of export profitability (see Table III-3), with all indicators pointing to a marked improvement between 1966 and 1972. The difference between these two periods can also be seen in a comparison of unit labor costs and export prices between Israel and the industrialized countries (Table V-9).

The period of a strong upsurge in export profitability, which lasted until the early 1970s, also saw Israeli exporters undercutting their competitors' prices,[12] thereby capturing a larger share of the market. What permitted this was not only a rapidly rising productivity, but also an increase in the effective exchange rate for exports. Between 1965 and 1972 unit labor costs in Israel[13] dipped 32 percent relative to the level in the developed industrial countries.[14] Thus, despite the relative decline in Israel's industrial export prices, labor costs per dollar of export fell sharply in comparison with its trade rivals.

These trends which accompanied the vigorous headway made by exports in a rapidly expanding economy were arrested after 1973. Between 1973 and 1978 unit labor costs more or less held steady. The need to reduce the relative price of exports was pointed up by the fact that labor costs per dollar of export went up 4 percent in comparison with Israel's competitors. This probably indicates that in the absence of any significant improvement in profitability during these years the Israeli exporter found it hard to lower his prices in order to boost foreign sales – and thus to absorb additional productive factors and to help steer the economy back to a growth path through export expansion.

Among the determinants of export growth in 1978 the crucial role played by domestic demands stands out. This is evident in the marked slowdown of exports against the background of a relatively modest upturn in domestic demands after a long bout of stagnation. This key role of domestic demands is explained by the market structure, in which a limited number of manufacturers producing for the local market enjoy a high degree of protection. This situation is characterized by price discrimination and large price differentials in favor of the domestic market. The expansion of domestic demands relative to production capacity alters the allocation of resources between the two markets,

[12] This makes it necessary to accept with caution the simplistic assumption that demand for Israel's export goods is infinitely elastic.

[13] In constant currency terms.

[14] See also Table IV-21 in the Bank of Israel Annual Report for 1975.

increasing the share of domestic at the expense of foreign sales. Such a change need not be accompanied by a rise in the price of domestic marketing relative to that of overseas sales; it can be accompanied even by a decline in the price. This does not mean that price changes and the profitability trend do not carry any weight in the development of exports; a rise in the ratio between export proceeds and costs tends to stimulate exports relative to the existing capacity. But there was no striking increase in this ratio in 1978. These price movements are relevant to any discussion of the existence of idle plant capacity and its influence on possible changes in exports.

3. The Capital Account

In 1978 there was a significantly larger inflow of capital to Israel. The growth of defense imports was accompanied by a \$ 600 million increase in U.S. government aid, bringing up the weight of this item to nearly 80 percent of the public sector's total capital import. There was a \$ 300 million increase in what was customarily defined as "long-term capital movements" to the private sector, although the recent changes in foreign currency arrangements have blurred the distinction between long- and short-term capital.[15] Most of the increment was in transfers by private individuals (including new immigrants), which rose from \$ 330 million to \$ 430 million. This was undoubtedly influenced by the liberalization of foreign currency control; it should also be regarded as part of the reshuffling of the private sector's assets portfolio induced by the conspicuous changes in the relative profitability of various assets in the wake of the steep rise in the exchange rate brought about by the reform and the booming domestic assets markets. The expansion of investments from abroad from \$ 100 million to \$ 180 million, which was apparently due primarily to the boom in the domestic real estate market and the rising return on investments in securities, especially when the adjustment of the exchange rate lagged behind the rate of local inflation, probably falls into the same category.

The inflow of what is defined as short-term capital also swelled. The amount of credit raised by the banks from overseas banking institutions reached \$ 560 million during the year, with the figure for the fourth quarter alone approaching \$ 450 million. This was a reflection of the shift to foreign credit with the institution of a tighter monetary

[15] The distinction between the various categories of capital flows became very blurred during this period. This applies in particular to transfers by private individuals. It has been clear for some time that this item reflects short-term influences more than bearing on ordinary unilateral transfers. This was accentuated by the foreign currency reform, in the wake of which this item more than tripled.

TABLE III-4

GROWTH OF ISRAEL'S INDUSTRIAL EXPORTS AND EXPORT MARKETS, 1966–1978

(percentages)

	Growth of Israel's export markets[a]	Growth of Israel's industrial exports[b]	Growth of Israel's share of export markets	
			Annual	Cumulative
1966	7.7	11.3	3.3	
1967	5.2	14.0	8.3	100
1968	13.6	31.3	15.6	15.6
1969	10.7	14.5	3.4	19.5
1970	8.3	15.8	6.9	27.8
1971	6.8	25.8	17.8	50.5
1973	11.6	(3.6)	(–7.8)	
1974	4.1	(8.2)	(3.9)	100
1975	0.4	5.2	4.8	4.8
1976	12.8	28.4	13.8	19.3
1977	6.4	17.0	10.0	31.2
1978	(6.0)	9.7	(3.5)	(35.8)

NOTE: The figures for 1973 and 1974 reflect the effects of the Yom Kippur War and hence are not indicative of the economic factors which are reflected more clearly in the figures for the other years. The data for 1978 are provisional.

[a] Excluding diamonds, minerals, and refined petroleum products.

[b] The rate of quantitative increase in the total imports of the countries of destination, weighted by each country's share in Israel's exports.

policy and the mounting attraction of domestic assets. These two factors braked the rise of the exchange rate and made it even more worthwhile to borrow abroad. The massive capital import in the fourth quarter can be partly attributed to the attempt to beat the expected restriction of this source of credit. A similar growth occurred in deposits by foreign residents, chiefly during the second half of the year, due to conditions abroad. The banks' total liquid liabilities abroad grew by more than $ 1,300 million, and net liabilities by close to $ 600 million.

The main identifiable items in the incremental capital inflow accounted for $ 2,400 million of the total growth; added to this was $ 300 million on the credit side in the errors and omissions item.[16] The total rise in capital imports far surpassed that in the current deficit ($ 840 million) and was reflected first and foremost in a $ 870 million expansion of foreign exchange reserves. The second asset item which increased was domestic bank deposits abroad, which were up $ 800 million.

The net growth in the banking system's overseas assets reached $ 300 million. As against this were several items which are essentially of a short-term nature, a product of the adjustment of the economy's assets portfolio: the expansion of private transfers and of foreign investments in Israel.

The picture of the capital account which emerges for 1978 is a complex one, with pronounced reversals of trends due to two central interrelated developments: the foreign currency reform and the revision of the exchange rate arrangements on the one hand, and the transition from a prolonged bout of economic stagnation to the resumption of growth (notably a boom in the assets markets) on the other. The most striking change produced by the liberalization of the foreign exchange regime[17] is a much closer integration of the domestic financial market with the overseas markets and the domestic foreign currency market. Such a change could greatly increase the intensity of the factors with which monetary policy has to cope. Floating the Israeli pound isolates the economy from external influences and endows monetary policy with freedom of action in attempting to achiëve its internal objectives; however, it has become clear that monetary policy cannot disregard the exchange rate, which is one of the key variables. This has created a dilemma from which there is no simple way out: choosing between the according of precedence to monetary targets at the expense of the exchange rate, and vice versa.

Another outcome of the reform and unification of exchange rates was a large devaluation for capital transactions (an immediate rise of 45 percent). This produced at one stroke large capital gains to holders of foreign currency assets and greatly altered the

[16] This indicates a shortfall of $ 300 million on the credit side. It is generally assumed that such omissions originate mainly in short-term capital flows.

[17] Including the public's interpretation of liberalization, which in many cases was far more sweeping than the changes in the regulations themselves, and which largely determined the actual practice in foreign currency transactions.

relative profitability of various assets. The result was a drastic adjustment of asset portfolios and a rapid change in prices. This provided fertile soil for the creation of a speculative boom in the assets market, in which self-fulfilling price expectations attracted speculative capital from abroad, thus accentuating the boom. This was accompanied by a diminished awareness of the severity of the balance of payments problem on the one hand, and the relaxation of economic restraints and a rise in real incomes (against the background of the election year) on the other.

The steep jump in the exchange rate for capital transactions, along with the expectation of domestic price rises, immediately increased the anticipated relative profitability of domestic assets and triggered a shift to linked assets in Israeli currency. The adjustment pattern, however, was more complex this time, because the reform added a new type of asset to the public's portfolio: foreign currency accounts in Israeli banks.[18] The switch to such accounts gathered strength during the first quarter of 1978, and the continuation of this trend further fueled the boom in the domestic asset markets, enhancing the attraction of investment in such assets relative to foreign credit (which has a greater supply elasticity than domestic credit). This increased the worthwhileness of transferring short-term capital from abroad via its impact on the exchange rate and its expected development as well as the feedback effect which this had on the profitability of financial sources relative to the uses of the funds.

Another factor at work during this period was the institution of a tighter monetary policy as part of the effort to stem inflation. This altered the relative profitability of domestic and overseas credit sources, with the latter becoming increasingly profitable through its impact on the exchange rate and exchange rate expectations. These asset market and credit trends apparently overlapped each other to a large extent, and together they accentuated the dominant trends.

The combination of these factors – the increasing financial integration and the sharp changes in the rates of return and interest against the background of portfolio adjustments and rapid inflation – made for a potentially highly unstable situation in which deviations from equilibrium fail to generate countervailing forces, but rather reinforce themselves. Such deviations led to the restricting of short-term capital imports in 1978, at first in a moderate fashion, and later by means of a 10–12 percent increase in the price of foreign currency credit.

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[18] It appears that broad segments of the public took advantage of another channel, the holding of accounts in overseas banks, even though the currency control regulations permit this only under specific conditions.

TABLE III-5

ISRAEL'S TERMS OF TRADE FOR GOODS, 1969–1978

		Import price index	Export price index	Terms of trade	Import price index excluding diamonds	Export price index excluding diamonds	Terms of trade excluding diamonds
Annual data (1968 = 100)							
1969		105.0	104.7	99.7	104.4	103.7	99.3
1970		105.6	104.4	98.9	106.7	103.5	97.0
1971		109.2	108.4	99.3	111.9	105.6	94.4
1972		115.8	116.2	100.4	118.0	109.9	93.1
1973		148.1	142.9	96.5	151.3	131.5	86.9
1974		202.9	169.1	83.3	202.3	167.5	78.9
1975		211.9	177.0	83.5	222.2	181.6	81.7
1976		206.8	180.2	87.1	215.5	180.0	83.5
1977		225.1	209.0	92.8	230.7	192.0	83.2
1978		264.0	266.1	100.8	250.5	216.5	86.4
Quarterly data (1974 = 100)							
1975	I	110	107	97.3	111	111	100.0
	II	110	105	95.5	110	112	101.8
	III	104	103	99.0	104	107	102.9
	IV	101	103	102.0	101	106	105
1976	I	102.3	107.7	105.3	101.8	106.8	104.9
	II	104.2	103.5	99.3	103.4	104.6	101.2
	III	105.0	105.2	100.2	104.8	103.1	98.4
	IV	108.0	111.1	102.9	107.7	111.4	103.4
1977	I	110.1	114.5	104.0	110.1	112.1	101.5
	II	113.1	124.6	110.2	112.0	114.0	101.4
	III	115.3	129.5	112.3	113.8	117.3	103.1
	IV	118.3	136.5	115.4	115.6	119.0	102.9
1978	I	129.3	153.9	119.0	119.6	124.9	104.4
	II	135.8	156.4	115.2	120.4	125.6	104.3
	III	138.2	169.5	122.6	123.4	130.2	105.5
	IV	145.8	188.3	129.1	128.9	140.3	108.8

SOURCE: Central Bureau of Statistics.

4. THE BALANCE OF PAYMENTS PROBLEM

The balance of payments crisis, which was the cause of the turnabout in economic activity in 1973, has altered in character over time, but it continues to be the core of the problem confronting the economy. Its external manifestations have changed and its existence is more covert. Its initial most prominent expression – a precipitate jump in the deficit beyond the ability of the economy to finance it even in the short run – disappeared with the onset of economic stagnation (and the expansion of U.S. government financial aid), but it still casts a shadow over every area of the economy.

A solution of the balance of payments problem, with which policymakers have wrestled ever since 1973, necessitates a structural change in the economy with all that this implies for relative prices, incomes, and the weight of consumption in GNP[19]. Such a change would permit the large-scale diversion of resources from domestic uses to export, a precondition for overcoming the problem of financing the deficit and restoring the economy to its former vigorous growth path.

To effect this structural change required the cooling of the economy during the transitional stage, but in 1974–76 the damping of activity and flattening of growth did not result in the restructuring of the economy to a sufficient degree. An initial success in 1975 was followed by a retreat, and the efforts to alter relative prices were increasingly reflected in a cost-inflation.

The current deficit shrank significantly, but this was achieved at the cost of a cessation of economic growth.[20] The standstill made it possible to sharply cut back investments, thereby reducing domestic uses and freeing resources; this permitted the paring of the deficit and the expansion of consumption in an economy which had ground to a halt.[21]

Maintaining consumption at a level which the economy could not afford with the resources at its disposal, let alone the boosting of consumption, inevitably resulted in a much slower expansion of production capacity and a diminished potential for future growth.

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[19] For a detailed discussion see the Bank of Israel Annual Reports for 1976 and 1977.

[20] The business sector product in 1977 was 4–5 percent above its level on the eve of the Yom Kippur War. The total growth during the four years 1969–72 was 59 percent.

[21] Between 1972 and 1977 GNP expanded by IL 10.5 billion in constant (1975) prices, or at a 16 percent rate, but at the same time the purchasing power of GNP fell by 3–4 percent due to a worsening of the terms of trade. During the same period total consumption grew by IL 15.2 billion (27 percent).

Another striking feature of the four years of restraint was the fact that it applied only to the business sector while the public sector[22] continued to expand at an accelerating rate. During the previous period of growth, until 1973, the latter sector absorbed a third of the economy's additional manpower, but over the next four years it accounted for all the increment, and even in 1978 its share came to 60 percent. This undoubtedly had one conspicuous advantage, in that it prevented unemployment, but this short-term benefit involved a heavy price in the longer run.

The results of the economic policy during the period of restraint can be assessed on several levels:

(a) The extent to which the resources at the disposal of the economy were utilized.

(b) The impact on the rate of expansion of the economy's resources and on the potential for future growth.

(c) The allocation of resources among the different uses.

The turnabout in the utilization of production capacity was severe and distinct. While it was not reflected in a significant rise in unemployment, the decline in the economy's growth rate to the zero mark testified to the creation of hidden unemployment. The continuation of the standstill was accompanied by a reduction in the growth of the business sector's capital stock to half the normal rate,[23] with the complementary productive factor, labor, being entirely absorbed by the public sector.

The amount of slack capacity is a crucial point in evaluating the nature of the economic problem, but no clear answer can be given to this question. If the growth trends which typified the economy until the reversal of 1973 had persisted, the product of the business sector in 1978 would have been much higher than it actually was. With the prolongation of stagnation and zero growth, the incremental productive capacity of the business sector contracted; but even this smaller addition was enough to assure a significantly higher output had the long-term productivity trend continued. The failure of both output and inputs to expand apparently indicates the existence of idle capacity.

One can regard the behavior of producers – their heavier capital spending and greater demand for labor (as well as a much larger import) – as suggesting the absence of spare capacity. On the other hand, the increased subsidization of capital undoubtedly stimulated investment, while the rising demand for labor may have reflected an expected shortage in the near future. There is no denying that the picture is a problematic one.

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22 Including financial services.

23 This rate too, which was much higher than that required for current production, was achieved thanks to the heavy subsidization of capital, one of the factors in the unhealthy economic atmosphere during this period.

TABLE III-6

FOREIGN EXCHANGE RESERVES AND NET LIQUID FOREIGN LIABILITIES OF ISRAELI BANKS, 1970–1978
($ million)

		Total reserves of monetary authorities (1)	Deposits of banks in foreign banks (2)	Deposits of foreign residents (3)	Deposits and loans of foreign banks (4)	Foreign obligations of banks (3+4) (5)	Net liquid foreign obligations of banks (5+2) (6)	Bank credit to foreign residents
1970		483	369	317	97	414	45	
1971		758	677	528	458	986	309	
1972		1,297	1,139	673	670	1,343	204	
1973		1,979	1,328	904	838	1,742	414	
1974		1,258	1,246	1,062	1,102	2,164	918	
1975		1,289	1,225	1,297	1,391	2,688	1,463	
1976		1,463	1,381	1,365	1,572	2,937	1,556	
1977		1,770	2,053	1,575	2,069	3,644	1,591	451
1978		2,783	2,877	2,365	2,899	5,264	2,387	413
1977	I	1,599	1,222	1,356	1,384	2,740	1,518	
	II	1,638	1,374	1,427	1,480	2,907	1,533	522
	III	1,656	1,437	1,473	1,531	3,004	1,567	451
	IV	1,770	2,053	1,575	2,069	3,644	1,591	451
1978	I	1,980	1,751	1,735	1,717	3,452	1,701	
	II	1,944	1,963	1,868	1,936	3,804	1,841	370
	III	2,086	2,292	2,115	2,083	4,198	1,906	388
	IV	2,783	2,877	2,365	2,899	5,264	2,387	413

The heart of the problem is obvious. The existence of spare capacity is a measure of the price which the economy has paid, in the form of restraint and a cessation of growth, for resolving the balance of payments crisis. But if in reality there is no appreciable amount of idle capacity – despite the continued fairly rapid expansion of the economy's available factors of production, which has not found expression in the growth of output – then a new and much more serious situation has arisen: what began as a temporary toning down of economic activity is liable to prove to be a basic turning point in the economy's long-term growth capacity.

The fact that the business sector product hardly expanded (the total gain for the five years 1974–78 was about equal to that for a single year before then) does not point to a lack of available resources. Rather, it attests to an initial balance of payments constraint to which was added a distorted resource allocation, and perhaps also to a fundamental long-run change for the worse in the efficient use of the available productive factors and in the growth capacity of the economy.

Another aspect of the inept handling of the balance of payments situation is the distorted allocation of resources. One manifestation of this problem is the swelling of domestic uses relative to GNP. In 1978 total consumption was equivalent to 93 percent of GNP, compared with 83 percent in 1972 and 89 percent in 1973 (the comparison is in constant price terms and does not take into account the drop in the purchasing power of GNP due to a worsening of the terms of trade). The figure for investment on the other hand, fell from 35 to 25 percent.

These changes point up the nature of the long-term problem confronting the economy. A return to its previous growth trend without a further deterioration in the balance of payments entails, in the foreseeable future, a change in resource allocation and the boosting of investment to a point where its weight in GNP approximates that registered in earlier years. The alternative is reconciliation to the fact that the balance of payments crisis of 1973 constituted a fundamental turning point, with the economy slipping into a path of sluggish growth, low productivity, and a standstill in the standard of living, not merely in the short run but for a long time ahead.