CHAPTER II

# PRODUCT AND DOMESTIC DEMAND

Economic activity expanded in 1987 at an accelerated rate: the business sector product grew by some 7 percent, following a 5 percent average annual growth in the two preceding years, and an average annual increase of 3.5 percent since 1973. The expansion expressed itself in a substantial rise in productivity and employment, and a falling unemployment rate. The large increase in business sector employment was supported by restraint in employment in the public sector and nonprofit institutions.

Domestic resource use (excluding defense imports) continued to expand, albeit more slowly than in the previous year. The major source of the expansion was the considerable rise in private consumption and fixed investment, the impact of which was greatly dampened by a steep fall in inventory investment.[1] Domestic public consumption increased only slightly; its direct effect on domestic resource use was therefore correspondingly small. The domestic uses channelled to the business sector and the business sector product increased by 7.5 and 6.9 percent, respectively (see Table II–1b), so that by comparison with the previous year the civilian import surplus[2] widened only moderately in volume, accompanied by a slight real appreciation, i.e., a rise in the price of the business sector product relative to export prices. The increase in the share of the import surplus in GDP was higher, due to the deterioration in the terms of trade, which means an increase in real national expenditure.

The development of domestic uses (excluding stocks) during the year was similar to the pattern of the year as a whole—a high rise in private consumption and fixed investment, and a slower increase (albeit faster than the annual average) of public consumption. The steep fall in stocks in the second half of the year more than offset the expansion of other domestic uses. Exports and imports rose considerably during the year, while GDP growth was relatively moderate, reflecting a stabilization or even slight decline in the second half of the year, in line with the contraction of stocks and the rise in the civilian import surplus. The index of industrial production also points to a slight expansion in the course of the year, following its substantial rise during 1986. At the same time, the labor input in the business sector continued to rise rapidly.

[1] Despite its contraction, however, inventory investment remained positive in 1987.

[2] The import surplus is by definition the difference between domestic resource uses and GDP.

## Table II–1
## RESOURCES AND USE OF RESOURCES, 1984–87

| | At current prices, NIS million | | | Percent annual change | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Quantity | | | | | Price | | |
| | 1985 | 1986 | 1987 | 1981–87 | 1984 | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 |
| **Resources** | | | | | | | | | | | |
| GDP at market prices | 28,084 | 43,711 | 55,337 | 3.2 | 2.4 | 3.7 | 3.3 | 5.2 | 256.8 | 50.7 | 20.4 |
| Imports[a] | 16,606 | 23,275 | 32,341 | 6.4 | –0.7 | –1.0 | 8.9 | 18.7 | 296.8 | 28.7 | 17.0 |
| *of which:* Civilian imports[b] | 14,181 | 21,105 | 27,635 | 6.8 | –3.7 | –3.8 | 15.2 | 11.1 | 302.7 | 29.2 | 17.9 |
| Total resources | **44,690** | **66,987** | **87,678** | 4.4 | 1.2 | 1.8 | 5.5 | 9.9 | 271.3 | 42.1 | 19.1 |
| **Use of Resources** | | | | | | | | | | | |
| Private consumption | 16,425 | 27,341 | 35,353 | 6.1 | –6.8 | 0.5 | 14.2 | 8.1 | 295.7 | 45.7 | 19.6 |
| Public consumption | | | | | | | | | | | |
| Total | 10,495 | 13,899 | 19,488 | 1.3 | 6.3 | 3.3 | –10.1 | 16.1 | 243.9 | 47.3 | 20.8 |
| Excl. direct defense imports | 8,071 | 11,729 | 14,782 | 0.8 | 1.5 | –1.0 | –3.5 | 1.8 | 241.7 | 50.6 | 23.8 |
| Gross domestic investment | 5,251 | 8,585 | 10,968 | 1.7 | –6.9 | –10.7 | 9.3 | 3.8 | 257.9 | 49.6 | 23.1 |
| *of which:* Fixed investment[c] | 5,275 | 7,796 | 10,884 | 1.7 | –11.3 | –7.8 | –1.6 | 13.7 | 267.6 | 50.2 | 22.8 |
| *Subtotal:* Domestic resource use, excl. direct defense imports | 29,747 | 47,654 | 61,102 | 3.8 | –4.7 | –2.2 | 8.4 | 5.8 | 272.7 | 47.8 | 21.2 |
| Exports[d] at local market prices | 12,519 | 17,161 | 21,869 | 5.9 | 13.9 | 8.5 | 5.6 | 10.8 | 273.1 | 29.9 | 15.0 |
| Total resource use excl. direct defense imports | 42,265 | 64,816 | 82,971 | 4.4 | 0.1 | 0.9 | 7.5 | 7.1 | 272.1 | 42.7 | 19.5 |
| Total use of resources | **44,690** | **66,987** | **87,678** | 4.4 | 1.2 | 1.8 | 5.5 | 9.9 | 271.3 | 42.1 | 19.1 |
| Net factor payments to rest of the world | 1,046 | 1,641 | 1,932 | 3.8 | | | | | | | |
| GNP at market prices | 27,038 | 42,070 | 53,405 | 3.1 | | | | | | | |
| Business sector GDP at market prices[e] | 19,521 | 30,939 | 39,248 | 4.0 | 2.8 | 5.0 | 5.3 | 6.9 | 262.4 | 50.6 | 18.7 |

[a] Imports c.i.f., not including factor payments and interest payments of the public sector to the rest of the world.
[b] Total imports less direct defense imports.
[c] Total investment less investment in stocks.
[d] Exports f.o.b., not including factor payments from the rest of the world and interest received by the public sector from the rest of the world.
[e] GDP, less product of public services, private nonprofit institutions, and housing services.

SOURCE: Central Bureau of Statistics.

**Table II–1a**
**RESOURCES AND USES, QUARTERLY DATA, 1985–87**
**(Seasonally adjusted, percent real change)**

| | 1985 | | | | 1986 | | | | 1987 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II | III | IV | I | II | III | IV |
| 1. Private consumption | 4.2 | –1.0 | –6.0 | 11.7 | 3.3 | 2.5 | 4.7 | 1.2 | 1.6 | 1.2 | 3.0 | 0.4 |
| 2. Public domestic consumption | 1.8 | –1.8 | –2.4 | –0.9 | –0.5 | –0.9 | 0.1 | –0.1 | 0.8 | 0.9 | 0.7 | 0.4 |
| 3. Fixed investment[a] | –2.3 | 1.2 | –6.8 | 7.8 | –5.9 | –1.8 | 7.2 | –1.5 | 7.6 | 0.7 | 2.9 | 1.0 |
| 4. Total domestic uses (1+2+3) | 2.3 | –0.8 | –5.1 | 7.3 | 0.6 | 0.9 | 4.0 | 0.4 | 2.4 | 1.0 | 2.4 | 0.5 |
| 5. Exports of goods and services[b] | 2.9 | 2.1 | –1.6 | 4.8 | –0.2 | 1.7 | 3.9 | –4.5 | 5.4 | 6.5 | 3.8 | –2.2 |
| 6. Civilian imports of goods and services[a,c] | –2.7 | 6.0 | –9.7 | 13.2 | 1.7 | 6.0 | 5.7 | –3.8 | 6.2 | 0.6 | 4.4 | 2.1 |
| 7. Civilian import surplus (6–5) | –34.9 | 42.0 | –63.0 | 159.6 | 15.4 | 29.9 | 13.3 | –0.9 | 9.4 | –21.0 | 7.5 | 22.7 |
| 8. Gross domestic product | 3.4 | 0.9 | –4.3 | 1.1 | 5.6 | –1.5 | 0.6 | 3.6 | 0.0 | 3.3 | –0.2 | –0.9 |

[a] Excluding ships and aircraft.
[b] See note *b* to Table II–1.
[c] See note *a* to Table II–1.

SOURCE: Central Bureau of Statistics.

*A. The Determinants of the Business Sector Product*

The 6.9 percent growth of the business sector product in 1987 was significantly higher than the average of the last two years (some 5 percent a year) and the multi-annual growth rate attained in the period after 1973 (about 3.5 percent a year). Together with the growth of product, productivity (both total and labor productivity) rose in the last three years at an average 3.5 percent a year (see Table II–2). These productivity gains had a significant share in speeding up the economy's growth rate in these years, as they contributed some 60 percent of the incremental business sector product.

The substantial rise in the business sector product and the domestic uses channelled to it—associated with a slight appreciation of the real exchange rate and a moderate increase of the civilian import surplus—apparently reflects a great expansion of both demand and supply, although the latter lagged slightly behind the growth of domestic demand.[3]

Several factors on the supply side operated to increase GDP: a) the steep decline of the inflation rate after the adoption of the stabilization program in July 1985 reduced uncertainty, and induced producers to give greater weight to efficient production and the expansion of activities as sources of higher profits, rather than engaging in financial speculation, as was done in the period of galloping inflation; b) the balancing of the public sector accounts and the reduction of government involvement in the capital market also helped to enhance the sense of stability and expectations of accelerating economic activity.

Direct corporate taxes were cut in 1987 and raised net profits in the business sector; net non-wage real income, which had fallen significantly in the preceding two years, rose this year by some 6 percent.

One goal of economic policy was to bring about a structural change in the economy; employment in the public sector and the nonprofit institutions was cut, thereby releasing resources for the business sector. In 1987, public sector employment (including nonprofit institutions) remained unchanged for the second year running, while business sector employment rose in these two years by 6.5 percent.

In view of these developments it would be reasonable to suppose that the large increase of the business sector product mainly reflected supply expansion; this, however, should have reduced the price of the domestic product relative to export prices, and narrowed the import surplus. Instead, there was some real appreciation and a moderate increase in the import surplus. The explanation for the real appreciation may lie in the possibility that in 1987 supply expanded mainly in sectors producing

[3] It should be emphasized that expansion of demand or supply refers to a shift on their respective schedules, and not to an increase in the quantity demanded or supplied (a movement on the curve).

tradeable goods,[4] the prices of which are determined in the international market. At the same time, demand for nontradeable goods, particularly construction, went up, and their relative prices rose. A preliminary examination indicates that in the tradeables sector product growth was above average, but its quantitative contribution to total GDP growth was only slightly greater than that of the nontradeables sectors.[5]

While some factors were conducive to supply expansion, others had a contractionary influence: real wages increased further, by 2.5 percent in excess of productivity growth, and the real interest rate rose further, above the already high level it had reached in recent years.

The continued great expansion of domestic demand (by 5.8 percent), and primarily the demand directed towards the business sector (7.5 percent) at the same time well accords with the hypothesis that it was the large incremental demand which reflected itself in the high growth of the business sector product, in association with a real appreciation of the exchange rate and a greater import surplus. Moreover, the resource uses relevant for causing the real appreciation may be those net of investment in stocks

**Table II–1b**
**DOMESTIC USES DIRECTED TOWARDS THE BUSINESS SECTOR, 1984–87**
(Percent annual change, quantities)

| | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|
| Domestic use of final goods and services[a] | –5.6 | –1.5 | 6.4 | 7.5 |
| Total domestic uses[b] | –4.7 | –2.2 | 8.4 | 5.8 |
| Product of housing services | 2.9 | 2.5 | 1.8 | 1.6 |
| Product of public services and nonprofit institutions | 1.1 | –0.4 | –2.9 | 0.7 |
| **Total domestic uses directed to business sector** | **–6.8** | **–3.2** | **12.1** | **7.5** |
| Total domestic uses, excl. fuel and diamonds | –7.6 | –3.2 | 10.2 | 8.7 |
| Gross domestic product of the business sector | 2.8 | 5.0 | 5.3 | 6.9 |

[a] Private consumption plus public consumption plus fixed investment.
[b] Domestic uses of final goods and services plus investment in stocks.

[4] In recent years supply apparently expanded somewhat more rapidly in the tradeables sectors than in those producing nontradeables. This supposition finds support in the fact that the capital stock in industry grew slightly faster than that of the business sector as a whole.

[5] The examination was for the business sector product without agriculture, so as to eliminate the effects of natural causes. The 'tradeables' sectors were taken as including industry, international transport (aviation and shipping), and tradeable services (mainly tourism). The share of these sectors in total business sector product is 48 percent, as defined above. Their average growth in 1987 was 7.5 percent, and their total contribution to the nonfarming business sector product was 3.5 percent. The total growth of the business sector product as defined above was 6.5 percent.

**Table II–1c**
**NATIONAL SAVING, GROSS DOMESTIC INVESTMENT, AND EXTERNAL CURRENT ACCOUNT, 1976–87[a]**
(Percent of GNP, current prices, at official exchange rate)

| | 1976–80 | 1981–84 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|
| 1. National saving out of economy's total income | 20.9 | 17.9 | 25.7 | 21.6 | 18.3 |
| Excluding the $750 million emergency grant | | | (22.6)[b] | (19.1)[b] | |
| *of which:* Public saving[c,d] | | –5.5 | 4.2 | 6.2 | 4.1 |
| Private saving | | 23.4 | 21.4 | 15.4 | 14.3 |
| 2. Total domestic investment | 24.0 | 22.1 | 18.3 | 19.0 | 19.1 |
| *of which:* Stocks | 1.8 | 0.3 | –0.1 | 1.7 | 0.1 |
| Economic sectors | 14.8 | 13.9 | 13.3 | 12.7 | 14.1 |
| Dwellings | 7.4 | 7.9 | 5.1 | 4.6 | 4.9 |
| 3. Net external current account, adjusted[e] (1)–(2) | –3.1 | –4.2 | 7.3 | 2.6 | –0.8 |
| *of which:* Civilian import surplus | 8.8 | 8.7 | 3.9 | 5.5 | 6.4 |

[a] Total income of the economy equals GNP plus net unilateral transfers from abroad, valued at the representative exchange rate. The GNP is estimated in accordance with the definitions of the new System of National Accounts of the United Nationas Statistical Office.

[b] Excluding the U.S. emergency grant of $750 million.

[c] Calculated according to real interest payments.

[d] No breakdown of savings by the two sectors is available for 1976–80, due to changes in definitions.

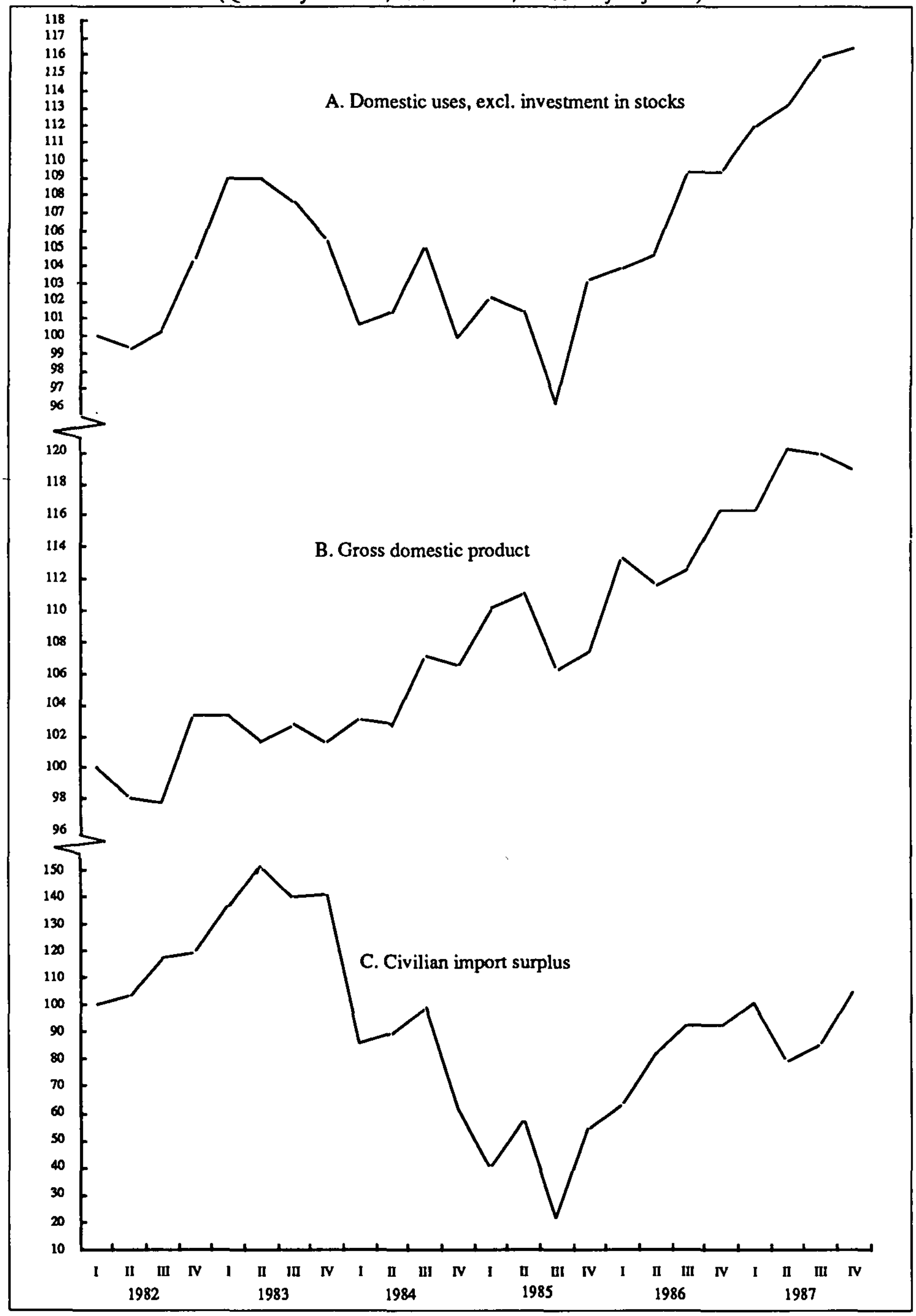
[e] Advance payments on account of future supplies of defense matériel are considered as actual imports and included in direct defense imports.

of diamonds and fuel, and possibly net of total inventory investment.[6] These uses indeed expanded by 8.7 percent, as compared with a 6.9 percent growth of business sector product (see Table II–1b).

[6] Investment in stocks of fuel and diamonds is subject to wide fluctuations. Thus, for example, in 1986 it amounted to 1.1 percent of GDP (1986 prices), and declined to 0.3 percent of GDP in 1987. Fuel stocks are managed by the government, and are therefore not determined primarily by market forces. The value added of the diamond industry is very small (less than 20 percent of output value), and almost the entire output is destined for export. Domestic economic developments therefore have very little effect on the industry. It is therefore not clear how the fluctuations of inventories in these industries affect domestic demand and relative prices.

Total investment in stocks has fluctuated exceptionally widely in the last two years. In 1986 inventory investment was four times its 1980–85 average, which means an increment of 1.8 percent of GDP; in contrast, in 1987 this investment contracted to 0.1 percent of GDP. Moreover, the high inventory investment of 1986 (even net of fuel and diamonds) is especially remarkable in view of the then prevailing high interest rate and the financial difficulties in certain sectors. It is therefore possible that for the major part the large size of this investment represents involuntary accumulations of stocks by enterprises that had ran into marketing difficulties. The steep fall in stocks in the second half of 1987 may be evidence for a liquidation of these involuntary stocks. If that was the case, the fluctuations in stocks show that demand expanded more rapidly than GDP.

**Figure II–1**
**DOMESTIC USES, CIVILIAN IMPORT SURPLUS, AND GDP, 1982–87**
(Quarterly indexes, 1982 I = 100, seasonally adjusted)



From what has been said above it may be deduced that the high product growth in 1987 was due to both demand and supply expansion (although supply growth may have been somewhat less than the increase in demand). In 1986, by contrast, the entire product growth reflected a sharp rise of domestic demand, while supply may even have contracted. The large wage increases in 1986—beyond the rate warranted by the employment situation and productivity growth (the wage increases were apparently mainly due to exogenous factors)—reduced business sector profitability, as expressed in the considerable decline in returns per unit of capital, and held back a more rapid growth of output as called for by the substantial increase in domestic demand.[7] These

**Table II–2**
**PRODUCT AND PRODUCTIVITY OF THE BUSINESS SECTOR, 1961–86**
(Real average annual rate of change, percent)

| | 1961–1972 | 1973–1987 | 1978–1981 | 1982–1984 | 1985–1987 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Product**[a] | | | | | | | | | | |
| Estimate A | 10.0 | 3.6 | 4.9 | 1.9 | 5.7 | 3.1 | 2.8 | 5.0 | 5.3 | 6.9 |
| Estimate B | 9.1 | 3.5 | 3.9 | 2.4 | 4.7 | 4.0 | 1.0 | 2.6 | 4.1 | 7.3 |
| **Factor input** | | | | | | | | | | |
| Labor (man-hours) | 3.6 | 1.4 | 2.2 | 1.9 | 2.1 | 3.4 | 2.1 | 0.1 | 2.2 | 4.1 |
| Capital stock[b] | | | | | | | | | | |
| Gross | 8.7 | 4.7 | 4.1 | 3.5 | 2.7 | 3.2 | 4.6 | 3.1 | 2.5 | 2.4 |
| Net | 8.0 | 3.5 | 2.4 | 2.8 | 1.2 | 2.3 | 4.7 | 2.0 | 0.8 | 0.8 |
| **Productivity** | | | | | | | | | | |
| Product per man-hour | | | | | | | | | | |
| Estimate A | 6.3 | 2.2 | 2.7 | 0.1 | 3.5 | –0.3 | 0.6 | 4.9 | 3.0 | 2.7 |
| Estimate B | 5.3 | 2.1 | 1.6 | 0.6 | 2.5 | 0.6 | –1.1 | 2.5 | 1.9 | 3.1 |
| Capital stock[b] per man-hour | | | | | | | | | | |
| Gross | 5.0 | 3.3 | 1.8 | 1.6 | 0.5 | –0.2 | 2.4 | 3.0 | 0.3 | –1.7 |
| Net | 4.2 | 2.1 | 0.1 | 0.9 | –0.9 | –1.1 | 2.5 | 1.9 | –1.3 | –3.2 |
| Total productivity[c] | | | | | | | | | | |
| Estimate A | 4.5 | 1.1 | 2.0 | –0.5 | 3.3 | –0.2 | –0.1 | 3.9 | 2.9 | 3.2 |
| Estimate B | 3.7 | 1.0 | 1.1 | 0.0 | 2.4 | 0.6 | –1.8 | 1.5 | 1.8 | 3.6 |

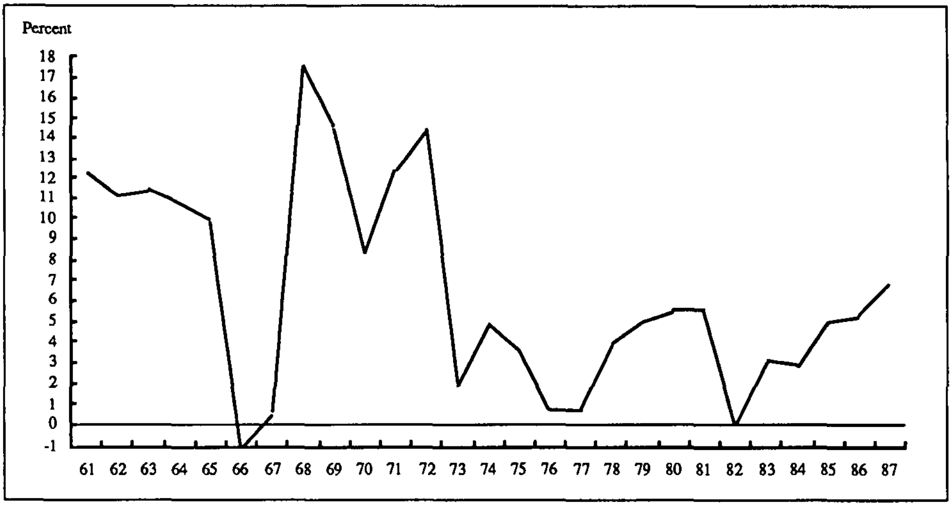
[a] Estimate A measures the product from the expenditure side (national accounts). Estimate B is based on various indicators of output volume by industry.

[b] Beginning-of-year stock.

[c] The weights are 0.68 for labor and 0.32 for capital, based on distributive shares of gross national income (long-run average) and examination of the 1977/78 input-output table.

[7] The decline in profitability was partly offset by the slowing of inflation, which tended to expand supply; the great expansion of domestic demand therefore expressed itself in a large increase of the product.

Figure II-2
DOMESTIC PRODUCT OF THE BUSINESS SECTOR, 1961–87
(Quantity change, estimated from resource uses)




developments reflected themselves in a real appreciation, a large diversion of domestic demand to imports, and a slowdown of export growth, so that much of the incremental demand was supplied by a great increase in the import surplus.

The year under review was the third consecutive year of significant growth of business sector product and productivity, following sluggish annual product growth and falling productivity in the years 1982–84. Two main stages are discernible in this revival of growth: in the first stage, from end-1983 to July 1985, domestic demand shrank considerably, accompanied by a real depreciation and GDP growth, which together reflected themselves in a sizeable narrowing of the import surplus. This development was supported by the shift in economic policy at the end of 1983: following the stock market crash of October 1983, an end was put to the manipulation of the bank shares, accompanied by a sharp fall in their value, the currency was devalued by some 23 percent, and subsidies to basic products and services were cut sharply. The large devaluation and the deep cuts in subsidies led to a considerable acceleration of inflation and a sharp erosion of real wages. The real contraction of current income and assets operated to reduce domestic demand, supported by the steep rise, in 1984, of the real interest rate on overdraft facilities. As against this, the fall in real wages and labor costs to employers made it possible for product supply to expand and the import surplus to narrow. Also, the 'package deals' concluded between the government, trade unions and employers towards the end of 1984 and early 1985 made it possible for real labor costs to decrease, as the nominal devaluations exceeded the inflation rate. In fact, during 1984 and until the introduction of the stabilization program in July 1985, GDP grew by some 9 percent, or an annualized rate of 6 percent (see Fig. II–1). The narrowing of the gap between domestic demand and GDP assisted the success of the stabilization program (as explained below). In order to bring inflation down rapidly, measures were taken to synchronize the main nominal economic variables: the exchange rate and prices were frozen, after a one-time large raise; the cost-of-living agreement and other wage agreements were suspended and substituted by a special agreement which amounted to a significant erosion of real wages. These measures were accompanied by stringent fiscal and monetary restraint. The curbing of domestic demand was intended both to help slow inflation and further cut the civilian import surplus. The lower import surplus, together with the US emergency grant, enhanced the public's confidence in the government's ability to persist in holding the exchange rate fixed. This greater confidence helped to reduce inflation and strengthened the feeling that the economic crisis had been overcome. The steep slowdown of inflation laid the ground for the economic growth in 1986 and 1987, with a large rise in productivity.

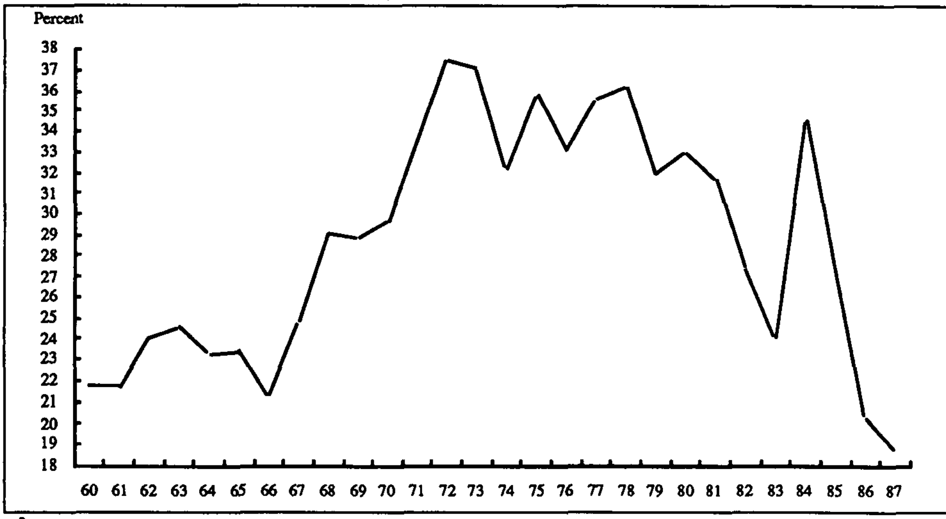
An examination of the contributions of the various resource uses to the changes in business sector product (based on input-output analysis—see Table II–3) shows that the contribution of exports increased, but in 1987, too, the biggest contribution to product growth came from domestic demand. This stands in contrast to the years 1981–85, when, on average, exports and domestic demand made a similar contribution to GDP growth (see Appendix Table II–A1).

*B. The Determinants of Domestic Resource Use*

Domestic uses, excluding direct defense imports and investment in stocks, continued to expand in 1987 at about the previous year's rate, following their substantial contraction in 1984–85 (see Table II–1b). This year, too, most of the expansion was in the private business sector, which increased its domestic demand by some 9 percent, following an 11 percent rise in 1986 against the background of a fiscal policy which, having been very tight since mid-1985, became slightly expansionary in 1987. This easing of fiscal restraint expressed itself in a 3.5 percent higher domestic demand[8] (in volume) of the public sector, including nonprofit institutions. The effect of this rise in demand on disposable income, however, is obtained by measuring it in purchasing power terms. This implies the inclusion of another 3.5 percent—the rise in the price of

[8] Domestic demand of the public sector (including nonprofit institutions) equals its domestic consumption and investment in the economy's industries.

**Figure II–3**
**PRIVATE SAVING RATE OUT OF DISPOSABLE INCOME FROM ALL SOURCES, 1960–87[a]**
(Calculated on the basis of long term real interest on the domestic public debt)




[a] For 1960–79, the line is changed on the basis of 1980 to accord with the new system of national accounts (SNA).

public sector demand relative to the price of private consumption.[9] As against this, there was no change in net income[10] as a proportion of GNP (at the representative exchange rate), which had risen significantly in 1986. Nevertheless, it seems that the easier fiscal policy of 1987 can explain only part of the large increase in the demand of the private sector, and additional factors seem to have been at work:

a) The last two years' stabilization of inflation at a level much lower than in earlier years affected domestic uses both directly (see below), and on the supply side, by increasing product and income, as explained earlier.

b) The migration balance (the sum of a slight rise in gross immigration and some decline in emigration) was positive in 1987, following two years in which it had been negative.

The increase in business sector investment, after three years of decline (see Appendix Table II–A16) is apparently a reflection of entrepreneurs' expectations that growth will continue in the future, as a result of the great lowering of inflation. This reduced their uncertainty, but these expectations made themselves felt with some delay, apparently because the implementation of planned investments needs time. The growth of

[9] The effect of public sector demand on disposable income also depends on households' propensity to consume.

[10] Total income from taxes and obligatory payments, less transfer payments and subsidies.

business sector product in the last two years, at a rate higher than the multi-annual average, probably also strengthened the expectations of continued future growth.

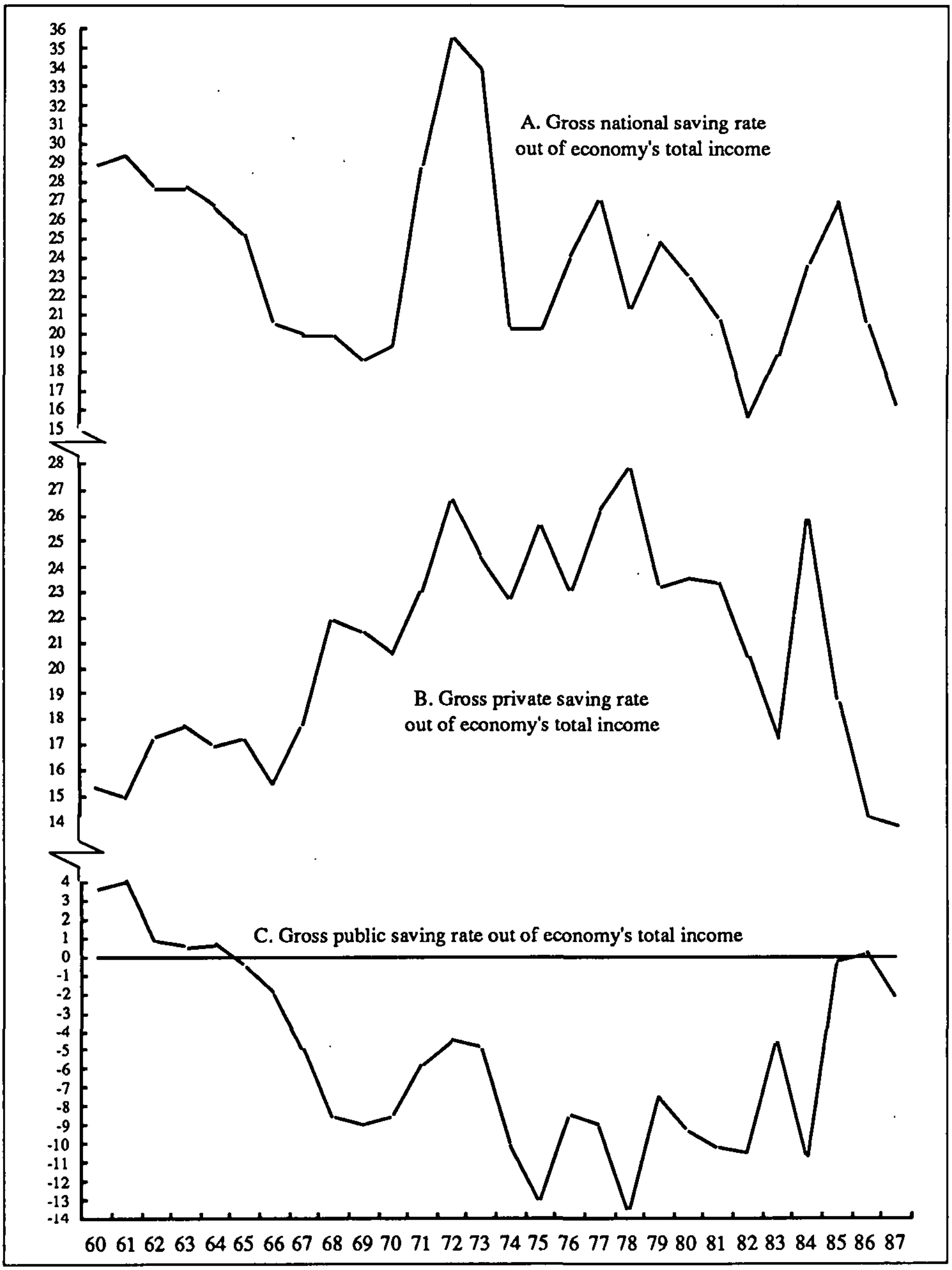
The recovery in residential construction possibly represents the end of the construction sector's adjustment to a lower level of demand than in the past. The timing of the turnabout seems to have been affected by the the last two years' large rise of disposable wage income and by the slight improvement in the migration balance.

The 8 percent increase in private consumption is only partly explained by the rise in disposable income from wages and current transfer payments (which increased by 7 percent in real terms, following a 15 percent rise in the preceding year), and by the slower increase in the private sector's wealth (some 4 percent, after having remained stable in 1986—see Appendix TableVIII–A9). The increase in private disposable income from all sources lagged slightly behind the rise of private consumption, which means a further slight fall in the private saving rate, to below last year's rate—the lowest since 1960 (see Fig. II-3). This development is puzzling and calls for explanation. The breakdown of total consumption by current consumption and acquisition of durable goods also points to a similar decline in the private saving rate. The distinction between the two categories of consumption is important because the acquisition of durables is a kind of investment by households, and the factors influencing these acquisitions are somewhat different from those involved in other investments.

The measurement of private disposable income and private saving does not distinguish between households and business firms, for lack of data and also because it is impossible to establish whether the fluctuations in the total private saving rate reflect a similar amplitude in the fluctuations of saving by households and business firms. Thus, for example, the sharp fluctuations in net undistributed profits of firms (which, as said before, are included in private sector saving) may have been caused by the upswings of inflation and the extreme changes in corporate taxes. These may have caused the private saving rate to swing more widely, particularly in 1986, when business profits apparently dropped steeply. It may also be that the considerable fall in the inflation rate in the last two years has diminished the sense of uncertainty about future economic developments, enhancing individuals' sense of security as regards their real wealth, thereby leading to a decline in the private saving rate in the last two years.

It has been suggested that individuals set their level of consumption in accordance with the changes in the real resources available to the economy, less the resources required for public consumption, and that private saving is in effect identical (in absolute amount) with national saving. This may be seen in Table II–1c: in the last two years the national saving rate was 18.5 percent of GNP (not including the U.S. emergency grant of $750 million in 1986). This rate is similar to the average of 1981–84, and slightly below that of 1976–80. Moreover, despite the stable level of the national saving rate, its composition changed greatly: public saving became positive,

**Figure II–4**
**GROSS NATIONAL SAVING RATE OUT OF ECONOMY'S TOTAL INCOME,[a] AND ITS DISTRIBUTION BETWEEN PRIVATE AND PUBLIC SECTOR, 1960–87[b]**




[a] For definitions and the method of calculation, see Appendix Table II–4.

[b] See note to Fig. II–3.

while private saving fell to half its 1981–84 rate. This trade-off between public and private saving accords well with this so-called Ricardian approach.

### *C. The Import Surplus and National Saving*

As already said, the volume of the civilian import surplus rose in 1987 only moderately, accompanied by a real appreciation of the exchange rate and a rapid rise of both exports and imports. The accumulation of stocks, which had been exceptionally great in 1986, ceased, and this apparently had a role in slowing the increase of the import surplus. The considerable rise in exports (10.8 percent and, excluding diamonds, 9 percent) at the same time as a real appreciation occurred for the second year running, is puzzling. It should be pointed out that the considerable recovery of tourism from the low to which had declined in 1986 due to external factors, contributed significantly to the large export growth.

In 1987 total consumption—private and public— still expanded at a faster rate than the accelerated GDP growth rate (although the gap between them narrowed considerably by comparison with the previous year), which expressed itself in a further fall of national saving out of domestic resources (in real terms). This means that the quantity of the economy's own resources allocated to investment continued to decline, so that the rise in investment showed up in a larger civilian import surplus. Since the economy has sizeable additional income from grants and unilateral transfers from abroad, it is important to examine what part of domestic investment was financed by national savings from all sources (the remainder, by definition, is the net external current account). Table II–1c shows that the great improvement in the external current account in the last two years (excluding the US emergency grant), as compared with the average during 1981–84, almost entirely reflects the fall in investment in dwellings, while the national saving rate remained stable. Accelerated growth in the future requires stepping up the increase in the business sector's capital stock, which has slowed markedly in recent years. This means higher investment. In order to maintain a long-run business product growth of 6 percent per annum, the capital stock must increase by 5 percent a year, and the GDP share of investment in the economic sectors must rise by some 3.5 percent of GDP. With a technologically determined constant capital/product ratio, the GDP share of investment will have to be even higher. Without a rise in national saving, the foreign debt will therefore increase again.