CHAPTER VII

THE BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

The import surplus and the current-account deficit both declined in 1984. On the other hand, private capital imports declined substantially and the fall in foreign reserves persisted. The civilian import surplus (excluding net interest payments) fell by $1.25 billion,[1] the current account deficit (total import surplus *less* grants from abroad) by $750 million, and less short-term borrowing was needed to finance the import surplus. By contrast, private capital imports fell steeply, and in spite of the improvement in the current account and the rise in public sector capital imports, foreign reserves declined by $600 million (see Tables VII–1 and VII–2 and Figure VII–1). The external debt continued to grow, with net interest payments to the rest of the world rising by $0.5 billion.

The marked improvement in the civilian import surplus (excluding capital services) was chiefly the result of the contraction of domestic demand, owing to which the relative price of tradables rose and economic activity slowed down; at the same time, labor costs declined in dollar terms. The contraction of demand stemmed largely from the wealth and liquidity effects of last year's fall in share prices and from the cyclical decline in imports of durables. The fall in public sector investment and the rise in interest rates also played a part. The net effect of world developments on imports and exports was a small contribution to the reduction in the balance of payments; they also helped to cushion the economy against the effects of slackening domestic demand. Exports (excluding capital services) rose by 15 percent (recovery was slower in Europe, the chief market for Israeli exports, than in the United States). Industrial exports (particularly metals and electronics, in which the bulk of defense exports are concentrated) rose by 19 percent. Civilian imports (excluding capital services) decreased by 2.5 percent because of the steep fall in imports of consumer and producer durables.

The contrast between the behavior of the import surplus and private capital movements reflects on the one hand the absence of the large capital inflows mediated by the banking system (mainly foreign residents' deposits) and the capital imports for bank-share support in 1983; and on the other, the public's

[1] Direct defense imports and net capital services each rose by $0.5 billion in 1984, so that the total import surplus declined by $300 million.

Table VII–1

BALANCE-OF-PAYMENTS INDICATORS, 1977–84

	1977	1978	1979	1980	1981	1982	1983	1984
$ billion								
Current account deficit	0.3	0.9	0.9	0.8	1.5	2.2	2.3	1.5
Corrected basic deficit[a]	–1.0	0.03	–0.9	–0.2	–0.2	0.9	1.0	0.1
Net foreign debt	8.5	8.7	10.7	11.6	13.4	15.6	18.3	19.4
Foreign reserves[b]	1.8	2.8	3.2	3.5	3.8	4.3	3.8	3.3
Import surplus								
Total	2.4	3.1	3.7	3.8	4.4	4.8	5.2	4.9
Excl. net capital services	2.0	2.6	3.1	2.9	3.5	3.7	3.9	3.1
Excl. direct defense imports, net capital services	0.9	1.1	1.9	1.2	1.3	2.2	2.9	1.6
Exports, excl. capital services	5.3	6.3	7.5	9.0	9.3	8.8	8.9	9.7
Imports, excl. direct defense imports, capital services	6.3	7.4	9.4	10.2	10.6	11.0	11.7	11.3
Representative exchange rate[c]								
IS/$	1.05	1.75	2.54	5.12	11.43	24.27	56.23	293.21
IS/basket unit[d]	1.08	1.94	3.00	6.18	11.96	23.55	51.05	245.26
Indexes, 1977 = 100								
World trade (quantity)	100.0	106.0	112.9	114.6	115.7	112.8	115.1	125.2
Terms of trade (merchandise)	100.0	107.5	101.1	93.5	92.5	95.7	96.8	95.1
Relative prices[e]								
Imports	100.0	110.1	105.0	108.4	104.3	97.7	90.6	93.9
Exports	100.0	107.7	104.5	104.7	101.6	96.0	92.9	95.1

[a] See Table VII–6.
[b] Held by central monetary institutions.
[c] Annual average.
[d] See note b to Table VII–A13.
[e] Relative to domestic use of resources. The calculation excludes direct defense imports.

Table VII-2

THE BALANCE OF PAYMENTS, 1980–84[a]

($ million)

	1980	1981	1982	1983	1984
1. Net goods and services amount	-3,785	-4,387	-4,803	-5,178	-4,893
Private sector	-1,708	-1,755	-2,765	-3,419	-2,459
Public sector[b]	-2,077	-2,632	-2,038	-1,759	-2,434
2. Net unilateral transfers	2,972	2,932	2,617	2,859	3,344
Private sector	1,139	1,147	1,064	945	758
Public sector	1,833	1,785	1,553	1,914	2,586
3. Net current account (1.+2.)	-813	-1,455	-2,186	-2,319	-1,549
Private sector	-569	-608	-1,701	-2,474	-1,701
Public sector	-244	-847	-485	155	152
4. Net medium and long term capital	1,248	1,234	1,218	2,228	1,068
Private sector[c]	-125	-39	3	961	44
Public sector	1,373	1,273	1,215	1,267	1,025
5. Net basic balance of payments (3.+4.)	435	-221	-968	-91	-481
Private sector	-694	-647	-1,698	-1,513	-1,657
Public sector	1,129	426	730	1,422	1,177
6. Net short-term capital, movements	-105	385	312	-235	231
Private nonbanking sector	31	-28	161	112	-146
Public sector[d]	-135	413	151	-347	377
7. Capital movements of the banking system	83	762	1,627	236	-167
8. Errors and omissions	66	-431	-115	-501	-148
9. Increase (-) or decrease (+) in foreign reserves held by central monetary institutions[e]	-481	-495	-856	589	564

[a] See Tables VII-A7, VII-A9 through VII-A11 for further details. Figures may not add owing to rounding.

[b] The public sector deficit on goods and services account is defined as direct defense imports, government imports n.e.s., and net interest paid to rest of world *less* port services surplus (excluding fuel) and *less* communications services surplus.

[c] Includes net private investment from abroad.

[d] Includes net advances to American manufacturers by Ministry of Defense.

[e] Adjusted for changes in the value of foreign currencies against the dollar and for revaluation of foreign securities held by the Bank of Israel.

SOURCE: Based on data of the Central Bureau of Statistics.

desire to increase the share of foreign currency in its portfolio, a tendency reinforced by the steady deterioration of the balance of payments in 1981–83, by doubts regarding the government's willingness to deal with the problem by making budget cuts, and by the consequent concern about possible government measures to reduce the real value of financial assets. The resulting mood presumably also had an adverse effect on the terms at which the country can borrow abroad; however, it did prove possible to recycle the debt.

Israel's already large foreign debt rose from $18.3 billion at the end of 1983 to $19.4 billion at the end of 1984, a rise aggravated by the persistent drop in the surplus of short-term assets over liabilities. Net interest payments to the rest of the world rose considerably (see Table VII–9) and various indicators point to a serious increase in the debt servicing burden.

Behind this year's balance of payments are three years of deterioration: the import surplus and the current account deficit increased first, then the basic deficit, and eventually the foreign reserves shrank.

In 1980–83, the import surplus rose from $3.8 billion to $5.2 billion. The civilian import surplus (excluding capital services) increased much more rapidly, from $1.2 to $2.9 billion. At the same time, there was real appreciation of the IS, i.e. the relative price of tradables fell (see the last two lines of Table VII–1).

The rise in the import surplus and the appreciation of the currency were related, being mainly a response to the rapid expansion of domestic demand. Among the factors underlying this expansion, which was accompanied by a rise in real wages, were the expansionary fiscal policy of 1981, events in the capital market (especially the stock market), the war in the Lebanon, and the expectations generated by the slowdown in devaluation in late 1982 and early 1983. These forces pushed up the relative prices and the output of nontradables (particularly services), and reduced domestic production of tradables while increasing the demand for them. The import surplus widened in consequence, as did the gap between the growth rate of domestic resources and GNP (Figure VII–2 illustrates the consistent negative relationship between changes in the domestic resource-use/GNP ratio and the relative price of tradables). The world trade depression and the weakening of the European currencies also to some extent helped to widen the import surplus. However, the lower exports due to these factors also entailed lower imports, given the level of domestic demand, so that they hardly affected the magnitude of the import surplus (if exports had risen faster, imports would have risen to satisfy domestic demand and might even have increased demand somewhat to keep pace with the rise in product).

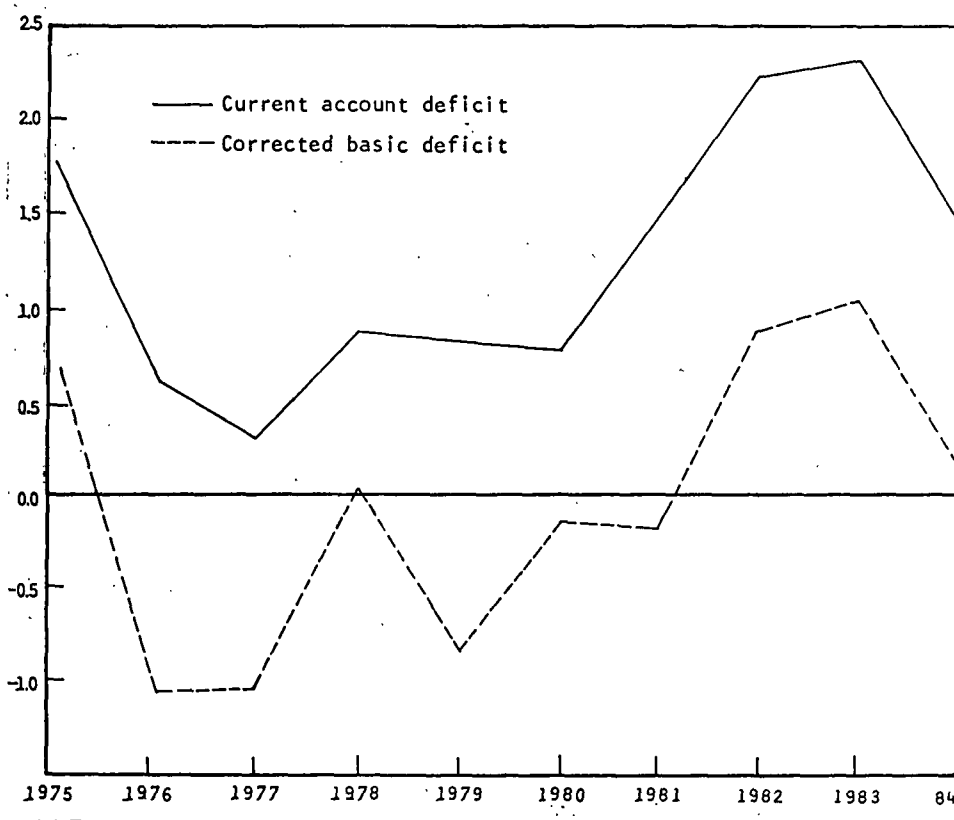
Unilateral transfers were stable in 1981–83 with public sector transfers rising and private transfers falling; the growth of the import surplus thus brought about a corresponding increase in the current-account deficit, which rose from $800 million in 1980 to $2.3 billion in 1983. During the same period, the debt grew by over 50 percent (to $18.3 billion at the end of 1983), and, together with the rise in world interest rates, this raised net interest payments to the rest of the world, which have become an important cause of the rise in import surplus and the current-account deficit.

Israel's large foreign debt (which comes to 85 percent of GNP) consists chiefly of the U.S. aid which helps to finance the heavy defense burden. In the past two years, the United States has increased the share of grants and advanced

Figure VII-1

DEFICIT ON CURRENT ACCOUNT AND CORRECTED BASIC DEFICIT, 1975–84

($ billion)



the timing of aid payments. The increased proportion of aid in the form of grants should moderate the growth of the debt and the interest payments on it. The structure of Israel's foreign debt is favorable both because the debt is largely intergovernmental, and because its average term is fairly long. However, the debt structure has deteriorated somewhat in recent years as the surplus of short-term assets over liabilities fell steadily. Moreover, the persistent rise in the debt/GNP ratio is a serious matter: the real marginal interest paid on it is high, whereas the growth rate and the marginal productivity of the investment it finances are low (and indeed in the last few years, most of the incremental debt has financed consumption and not investment).

Since 1982 the import surplus has exceeded the sum of grants and medium and long term credit (basic deficit[2]). In that year, short-term capital imports

[2] What is referred to here is the corrected basic account as defined in Section 3 (see Table VII-6 and notes 15, 16, and 17 below).

were used to finance the import surplus for the first time since 1975. This did not immediately reduce the country's foreign reserves, since the banking system imported substantial sums from abroad in 1981 and 1982 (mostly foreign residents' deposits), which seems to have postponed the pressure to improve the basic account. After a steep drop in the banking sector's capital imports, which was only partly offset by the exceptional rise in private investment (mostly connected with bank-share support), reserves dropped by $600 million in 1983.

In 1981–82, imports of producer and consumer durables rose, owing to the fall in their relative price and the general increase in wealth. In 1983, demand for foreign currency stepped up, and later in the year, as the balance of payments deteriorated further, shifted to financial assets, reflecting growing expectations of a large devaluation and a decline in share prices and fears of stricter foreign-currency control and a decline in the real value of local-currency financial assets.

The increase in the demand for foreign currency cannot be measured (especially the hoarded foreign cash balances), but its magnitude is indicated by the large increase in the private sector's foreign currency purchases in October 1983—$0.5 billion or one third of the entire year's volume (a large part of the increase is attributable to the exceptional rise in foreign currency purchases, ostensibly for travel abroad).[3]

In 1983, domestic demand and economic activity began to level off as expansionary forces worked themselves out and as import taxes were raised, and, later, devaluation accelerated and bank-share prices dropped steeply, so that the public's portfolio of liquid assets (and to a lesser extent its total wealth) declined. In 1984, the contractionary effects of reduced government investment and the real rise in interest rates were added to the picture. Domestic resource use (excluding direct defense imports) fell by 6.5 percent this year while the currency depreciated by a real 2.5 percent. The expansion of world trade in 1984 (even though the European currencies continued to weaken) lessened the adverse effects of the fall in domestic demand and shifted a large part of the reduced import surplus to exports, which in turn further reduced the import surplus slightly. At the same time, the inflation rate jumped, unemployment increased, and GNP growth slowed down.

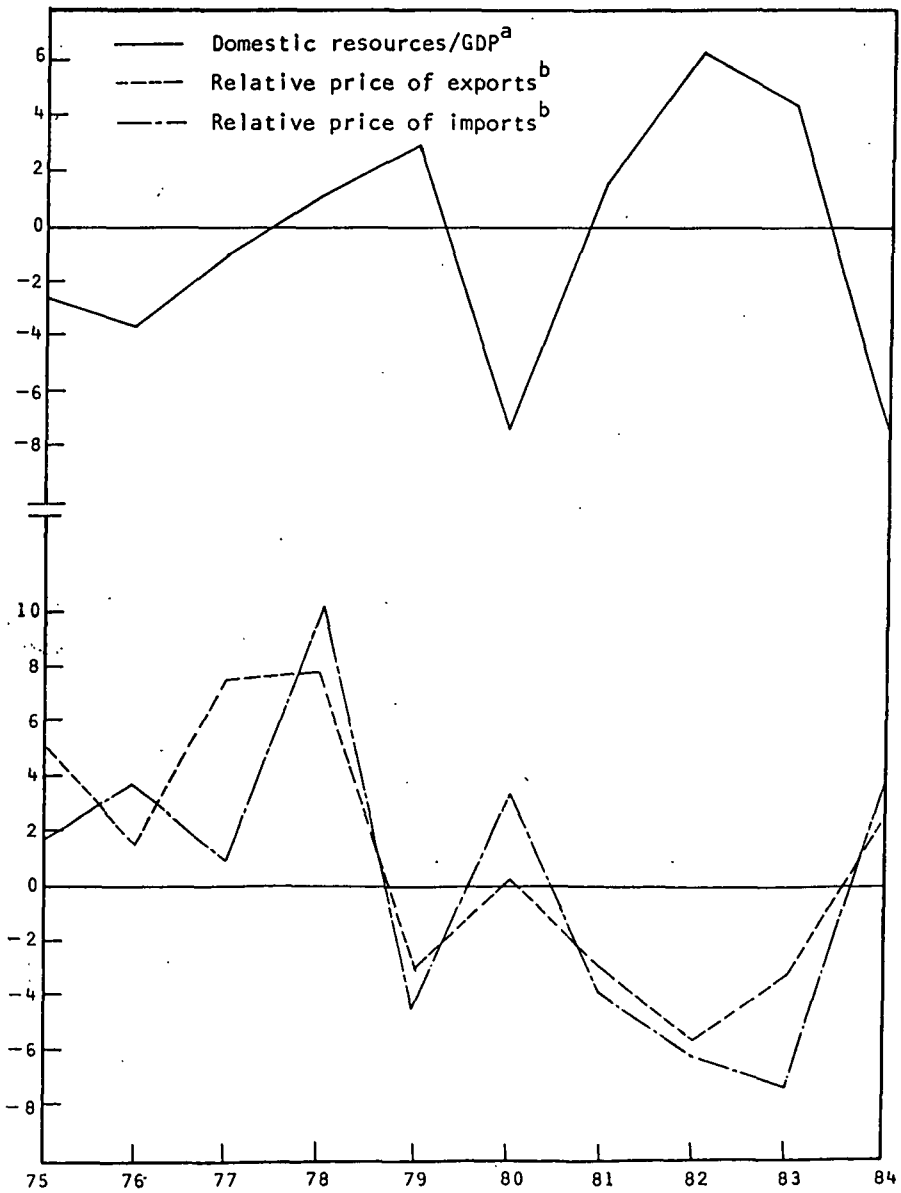
While the 1984 decline in the civilian import surplus (excluding capital services) was impressive, it did not result from any reduction in public sector consumption; rather, it was a reaction from previous advance imports of goods, the decline in private wealth (there has since been a large measure of recovery), and very high real interest rates, which the economy cannot afford for long. Lastly, the

[3] In the last quarter of 1983, the private sector balance of payments had a large E&O item (on the outflow side), which bears out the impression of large private foreign-currency hoards. Similar factors came into play in the third quarter of 1984, when E&O was also large (see below). Still, E&O is affected by many other factors and its level for the whole of 1984 was not exceptional.

Figure VII-2

RATIO OF DOMESTIC RESOURCE-USE TO GNP AND RELATIVE PRICES OF IMPORTS AND EXPORTS, 1975–84

(Percent change over preceding year)



[a] Excluding direct defense imports.
[b] See note e to Table VII-1.

interest burden again rose, and at a faster rate. Moreover, it will—in contrast to other civilian imports—continue to grow, along with the foreign debt.

The slow real depreciation of the currency, which was accompanied by accelerated devaluation and inflation in late 1983 and early 1984, is evidence of the limitations of using devaluation to depreciate the currency. On the one hand, the acceleration of inflation reduced private wealth by increasing the indexation loss on the redemption of government bonds; rapid devaluation also affected relative prices through adjusted lags, but this is only a short-run effect.[4] On the other hand, indexation and other adjustment mechanisms were not yet fully geared to the new level of inflation. As a result, tax revenue and the efficiency of production declined, and inflation may well have reduced the improvement in the import surplus. Finally, Israel's high inflation rates deter foreign investment and worsen the terms on which credit can be obtained abroad.

In spite of the contraction of the current-account and basic deficits, foreign reserves again fell in 1984, the result of the large decline in private capital imports, which was only partly offset by the rise in those of the public sector. Part of this decline is only a return to the normal level after the exceptional increase in 1983; part of it reflects the public's desire to increase the proportion of foreign currency in its net portfolio as a hedge against stricter foreign exchange control and a reduction in the real value of domestic financial assets. This is evidenced by, among other things, the large volume of private foreign currency purchases from the Bank of Israel in July and August, the high black-market exchange-rate in these months, and the decline in private short-term capital inflows and remittances and in foreign currency deriving from tourists (directly or through suppliers of tourist services) transferred to the Bank of Israel.[5] The demand for foreign-currency denominated assets was particularly strong before the elections and until the formation of the new government. Devaluation expectations may also have intensified during this period, but they were much less important than in 1983 (in any case, the public could open resident accounts as a hedge against devaluation).

Behind the increased demand for foreign currency lay the rapid expansion of the foreign debt and the deterioration of its structure and the growth of the domestic public debt, which created expectations of corrective measures. In the absence of adequate budget cuts, it was feared that assets would be taxed and foreign exchange control tightened. Growing doubts regarding the government's readiness to deal with the problem of long-term financing presumably also affected

[4] This could be seen when devaluation was accelerated and prices rose in the autumn of 1984, a period when the contractionary forces at work in late 1983 were absent.

[5] According to a rough estimate the private sector accumulated $1 million by not transacting foreign currency through the banking system and by unusually large drawings on the foreign reserves in the last quarter of 1983 and in 1984 (over half the amount in 1984).

foreign lenders, but this apparently affected the conditions of marginal credit rather than the ability to recycle the debt.

The private sector increased its financial savings in 1984, and apparently also the proportion of foreign cash and other unrecorded claims against foreign countries in its savings (imports of durables fell steeply). The public sector sold large amounts of foreign currency to the private sector, thereby shifting most of the financing of its domestic deficit to the balance-of-payments capital account, whereas net domestic borrowing was relatively small. The unrecorded accumulation of foreign-currency assets by the private sector may be regarded as transfer of part of the country's reserves from the government to the private sector—but this does not compensate for the loss of official reserves. The assets shifted to the private sector cannot be used in all types of current transactions and are not fully captured by the official statistics so that the net foreign debt is overstated; as a result, in addition to the interest forgone on hoarded assets, there is an increase in the marginal price of credit from abroad. Foreign reserves serve as an indicator of the economy's liquidity position at home and abroad. Considering the expectations and capital movements of the last two years, it would presumably have been better to reduce fluctuations in reserves by operating in the international financial market.

The short-term financing problems and the strong demand for foreign currency in 1983–84 and early 1985 led the government to retreat from its liberal foreign-exchange policy. Foreign currency allowances for a variety of purposes were reduced, the ceiling on foreign currency holdings was lowered, taxes were raised on some foreign currency transactions, and some import categories were temporarily prohibited. The black market for foreign currency, which had been dormant since the 1977 reform of the foreign-currency regime, began to revive in October 1983.[6]

Stricter foreign currency control is capable of reducing imports and capital exports in the short-run, and of curbing excessive speculative manifestations. But controls (such as the complex system of exchange rates discussed in the next section) have little effect on the import surplus and capital movements in the long run; moreover, they distort resource allocation. It follows that in the long run the balance-of-payments problem can be solved only by fiscal and monetary policy.

[6] Rate fluctuations in this market were largely the result of speculative transactions affecting the demand for foreign currency.

2. The Current Account[7]

In 1984, the government continued its efforts to reduce the deficit through import taxation, export incentives, and exchange-rate policy. These measures undoubtedly have an effect in the short run and explain some of the fluctuations in exports and especially imports during the year. However, their long-run effect on the import surplus is ambiguous: for the individual producer and consumer, a higher exchange rate, export subsidies, and import taxes make imports dearer and exports and import substitutes more profitable. If these were the only results of the policy, the import surplus would decline; but if a large number of producers try to increase the output of export and import substitutes when there is full employment, the industrial composition of output, factor prices, income, and the composition of demand will change. For this reason, the eventual effect on exports, imports, and the import surplus is not the same as the initial micro effects; instead, it is determined by the effect of the government's measures on domestic demand and product, since the difference between them is equal to the import surplus.

It should here be stressed that it is difficult to attain real depreciation of the currency by devaluation, especially in Israel, where the high price elasticity and a comprehensive indexation mechanism make it difficult to reduce domestic demand by eroding wealth. Hence the short-run effect of exchange-rate policy is negligible: like changes in the import surplus, changes in the real exchange rate are a response to changes in domestic use of resources and product.

Moreover, a system of taxes and incentives which equalizes the effective exchange rate for imports and exports has the same effect as an increase in the official exchange rate, although it discriminates between goods and services, on the one hand, and other balance-of-payments flows, on the other. In Israel, where taxes and subsidies are differential, the exchange rate system is less efficient. The result is a multiplicity of effective exchange rates which results in inefficient factor allocation. This regime was largely rooted in incomes policy, protectionism, and the desire to prevent unemployment; thus taxes discriminate against imports which have domestic substitutes. While this policy may be partly effective in the short run, in the long run, the resulting distortions get worse[8] and there is no guarantee that its goals are achieved.

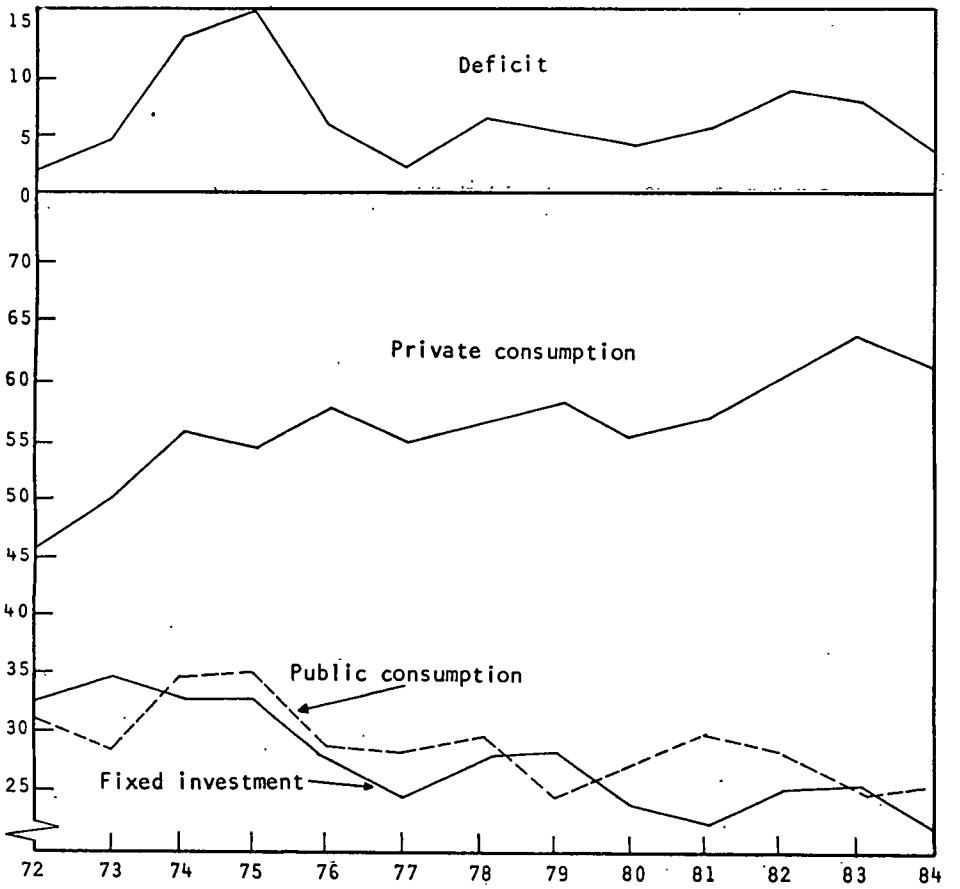
As can be seen in Table VII–1, the current-account deficit has been rising since 1980 and the import surplus for longer. This deterioration was not due only to fiscal expansion: public spending not financed by grants from abroad did rise in 1980 and 1981, but has been falling since. Private consumption rose throughout the period, causing the current account deficit/GNP ratio to double

[7] Unilateral transfers are discussed in Section 3 of this chapter.

[8] Thus firms are set up which would not be set up in the absence of subsidies.

Figure VII-3

THE DEFICIT ON CURRENT ACCOUNT (AT OFFICIAL EXCHANGE RATE) AND NATIONAL EXPENDITURE, AS PERCENT OF GNP, 1972-84[a]



[a] Private and public consumption are net of unilateral transfers to the private and public sectors respectively.

between 1980 and 1982 (see Figure VII-3). Towards the end of 1983, the deficit decreased slightly owing to an exceptionally high inflow of grants, but the import surplus continued to grow. This suggests that the problem stems partly from rising private consumption.

There were several reasons for the growth of private consumption, among them the indirect effect of government measures aimed at controlling inflation and reducing the current-account deficit. In 1981, with elections approaching,

effective exchange rates on imported consumer goods were lowered by cutting taxes; since it was announced that this was only a temporary concession, private consumption and consumer imports rose. In mid-1980, the dollar began to appreciate rapidly against most other currencies, including those of the European countries which are Israel's chief export market. This posed a serious problem, one which cannot be solved by exchange-rate policy. The government nevertheless speeded up devaluation in 1981, but was not able to prevent the real appreciation of the IS, which stemmed from increased domestic demand and was reflected in the considerable fall in European relative to Israeli prices (see Table VII–3 and Figure VII–4). At the end of 1982, devaluation was slowed down with the aim of reducing inflation. This was accompanied by higher subsidies and a rise in wages and was believed to be a temporary measure; as a result, private consumption and investment rose substantially, particularly their imported component. In the circumstances, the government resorted to exchange-rate substitutes to increase the price of imports and the profitability of exports.

When the slow devaluation policy was abandoned in mid-1983 and demand slackened (a cyclical reaction to three years of rapid growth) the relative-price trend changed (in terms of both the U.S./Israel ratio and the five-currency basket; see Table VII–3 and Figure VII–4). At the same time, import taxes were raised, and the sale of foreign currency was restricted. These and similar measures are certainly import reducing, but the main reason for the decline in the import surplus was the contraction of demand that set in at the end of 1983.

Table VII–3

RELATIVE PRICES OF INDUSTRIAL GOODS: ISRAEL AND SELECTED TRADING PARTNERS, 1980–84[a]

(Index, 1980 = 100)

	Trading partner ÷ Israel			4 European countries ÷ U.S.
	United States	Europe	5 basket countries[b]	
1980	100	100	100	100
1981	106	87	93	82
1982	104	78	86	75
1983	100	70	80	70
1984	107	69	81	64

[a] See note a to Table VII–A13.

[b] United Kingdom, West Germany, France, Netherlands, and United States.

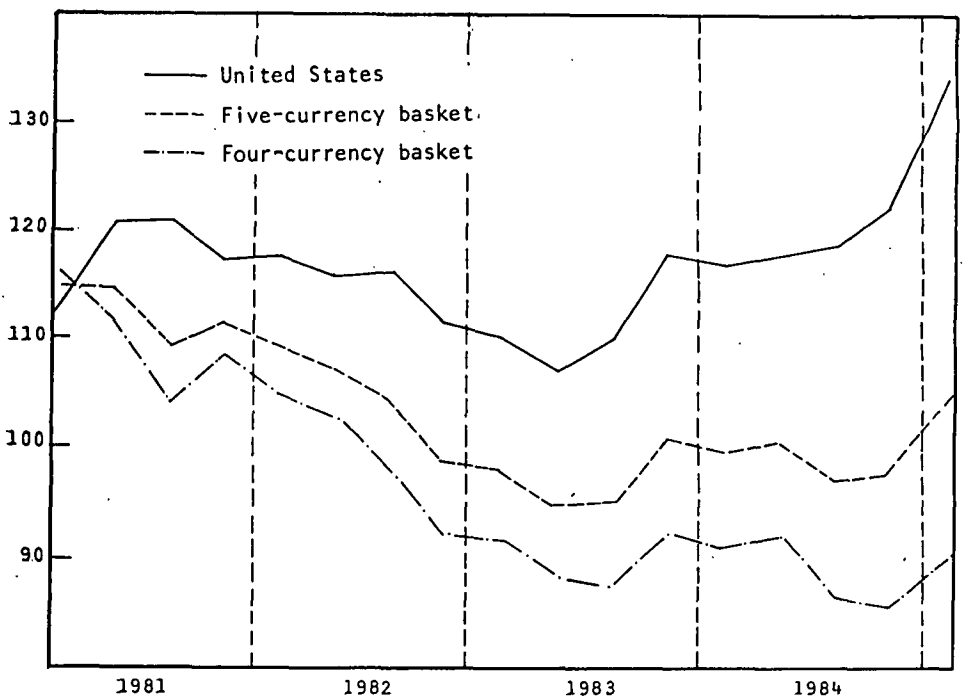
SOURCE: Bank of Israel.

The fall in domestic demand was due to depreciation of the public's portfolio (after the bank-share crisis), a small decline in the government's civilian demand, rising interest rates, and a stiff devaluation which halted the wave of speculative activity once expectations were realized. At the same time unemployment rose and real wages declined. Savings rose and domestic demand fell, which was consistent with the real depreciation of the IS; as a result, resources were shifted to export production, which gained momentum with world economic recovery, thereby moderating the contractionary effect of reduced demand. In mid-1984, as elections approached, the government's policy—and with it expectations—switched sharply: the downtrend of real wages was reversed, the rate of price increase on controlled goods was reduced, the decline in domestic demand was checked, and private consumption went up. Consequently imports rose, particularly

Figure VII-4

RELATIVE PRICES OF INDUSTRIAL GOODS—WORLD/ISRAEL, 1981-84[a]

(1980 = 100, quarterly data)



[a] Wholesale prices of industrial output abroad in IS terms *divided by* the appropriate domestic price indexes. The five currencies are the US dollar, the Deutsche mark, the pound sterling, the French franc, and the Netherlands guilder. The four-currency basket excludes the United States.

SOURCE: IMF, *International Financial Statistics*; Central Bureau of Statistics; and Bank of Israel calculations.

Table VII–4
GOODS AND SERVICES ACCOUNT, 1981–84[a]

	$ million				Percent annual change					
					Price			Quantity		
	1981	1982	1983	1984	1982	1983	1984	1982	1983	1984
Imports										
Goods, excl. fuel and diamonds[b]	4,983	5,209	5,769	5,365	–6.9	–3.9	–0.2	12.3	15.3	–6.8
Fuel	2,043	1,914	1,607	1,593	–12.9	–8.3	0.6	7.6	–8.4	–1.5
Diamonds	529	572	782	880	–8.5	–0.7	–2.7	18.1	37.8	15.6
Services, excl. capital services[b]	2,440	2,662	2,834	2,830	–2.1	–2.4	–3.3	11.4	9.1	3.3
From Judea-Samaria and Gaza District	621	620	734	606	3.0	12.1	–11.3	–3.0	5.6	–6.9
Subtotal	**10,616**	**10,977**	**11,726**	**11,274**	–6.7	–5.4	–1.4	10.9	13.0	–2.5
Capital Services	2,336	2,771	2,666	2,987						
Direct defense imports	2,205	1,508	1,053	1,490						
Total	**15,158**	**15,255**	**15,445**	**15,751**						
Exports										
Goods, excl. diamonds[b]	4,171	4,002	3,822	4,527	–5.4	–3.8	–1.0	1.4	–0.7	19.0
Diamonds	1,067	905	1,001	1,035	–5.9	–2.8	–6.0	–9.9	13.8	10.0
Services, excl. capital services[b]	3,256	3,102	3,175	3,329	2.9	2.6	–9.1	–7.4	–0.2	15.4
To Judea-Samaria and Gaza District	791	784	861	773	5.5	5.6	–4.7	–6.1	4.1	–5.8
Subtotal	**9,285**	**8,793**	**8,859**	**9,664**	–1.7	–0.3	–4.9	–3.7	1.0	14.7
Capital services	1,485	1,659	1,409	1,194						
Total	**10,770**	**10,452**	**10,268**	**10,858**						
Import surplus	1,331	2,184	2,868	1,610						
Civilian, excl. capital services										
Net capital services	851	1,112	1,257	1,793						
Civilian import surplus	**2,182**	**3,296**	**4,125**	**3,403**						
Total import surplus	**4,387**	**4,803**	**5,177**	**4,893**						
Trade deficit[b]	2,316	2,788	3,335	2,275						

[a] Imports c.i.f., exports f.o.b.

[b] Excluding trade with Judea-Samaria and the Gaza District.

SOURCE: Based on data of the Central Bureau of Statistics.

consumer goods (and within consumer goods durables), and there was a wave of speculative foreign-currency purchases. This intensified expectations of devaluation and other drastic measures after the elections. The government fulfilled these expectations by a 9 percent devaluation and by tightening import and foreign-exchange control. Obviously, these measures reduced imports, but it is not clear to what extent this improvement stemmed from their effects or from the fact that the public had previously advanced its purchases, including imports, so that imports would have fallen in any event.

At the end of 1984, as real wages fell and in the more relaxed mood resulting from the first package deal,[9] imports should have declined. However, the package deal froze taxes, including those on imports; the consequent decline in the relative price of imports stepped up demand for them, particularly for consumer durables. For this reason, the beginning of 1985 was marked by a small rise in the trade deficit.

Merchandise Imports[10]

The fall in domestic demand, particularly in private consumption and investment, improved the current account. On the import side, final consumer and investment goods contracted substantially (see Table VII–A1). Total imports were in fact unchanged, the net result of a $440 million rise in defense imports and a $400 million decline in civilian imports (6 percent); excluding fuel, the decline was 7 percent (compared with a rise of 15 percent in 1983). Intermediates (60 percent of nonfuel imports) rose by 6 percent and their prices also rose moderately.[11] As mentioned, the decline in civilian imports stemmed from the fall in final imports: capital goods (27 percent of total imports) fell by 10 percent, with the price down by 2 percent; consumer goods fells by 28 percent, with a 4.5 percent decline in price, reflecting chiefly a 40 percent decline in durables.

The increase in imports of intermediates is surprising, as is the rise in their prices, since import prices have been falling in the last few years and continued to do so this year—except for intermediates. This price rise is also inconsistent with the slight fall in world prices of raw materials. The rise in the volume of imported intermediates may indicate that producers increased their stocks in anticipation of a steep price rise and of government measures liable to disrupt supplies; but imports of capital goods, to which the same economic considerations apply, declined, as did consumer imports, so this cannot be the only explanation. Another possibility is that this is a good way of sending capital out of the country, but there is no way of checking this conjecture.

[9] The first package deal was signed in November 1984. Its most important provision was a price freeze.

[10] Excluding diamonds and imports from Judea-Samaria and the Gaza District.

[11] In this section, rates of change are in real terms unless otherwise specified. The prices referred to are in dollar terms.

The appreciation of the dollar had no effect on the geographical origin of imports, as can be seen in Table VII–A3; however, these figures were calculated from data in current dollars. Since there are no price indexes by trade regions and because relative prices between the United States and other countries have changed, the change in the volume of imports cannot be calculated.

Merchandise Exports[12]

The other side of the improvement in the civilian import surplus was the rise in exports, particularly merchandise (see Table VII–A5), to which world economic recovery contributed. All types of exports participated in the rise but it was especially pronounced in industrial exports (20 percent), with metals and electronics, which account for the bulk of defense exports, leading. Citrus exports declined by 11 percent and their price fell by 19 percent, while other agricultural exports rose by 18 percent.

Israel's main export market is Europe. However, the proportion of exports going there has been falling gradually for a number of years, with the United States taking an increasing share (24 percent of total merchandise exports this year). This shift has been quite slow both because Israeli producers have been slow to adjust to the changed market conditions, and because exchange-rate insurance cushioned exporters against deterioration of the relative profitability of their exports to Europe, thereby preventing the natural and desirable adjustment to the international changes in exchange rates.

Diamonds: Exports of diamonds rose by 3.5 percent, coming to $1,036 million in 1984. In spite of this, the export surplus again declined, reaching a very low level. However, the rise in diamond imports may be a sign that the industry is recovering, since stocks were run down substantially in 1980–82.

The Services Account

The services account continued to deteriorate, with the services import surplus going up by $350 million to reach $1.5 million in 1984 (see Table VII–A6). This rise stems entirely from a $0.5 billion rise in the deficit of capital services, itself the result of a $300 million increase in imports and a $200 million decline in exports: imports rose because the foreign debt grew and interest rates rose, while exports fell because of a $260 million decline in the foreign-currency assets of commercial banks and a $600 million decline in the Bank of Israel's foreign reserves (see Section 3 below).

When, however, we look at the aggregate that excludes capital services and

[12] Excludes exports to Judea-Samaria and the Gaza District. Diamonds are reviewed briefly at the end of the section, but are not included in the preceding discussion.

Judea-Samaria and the Gaza District, the export surplus rises by $150 million, as a result of a substantial 15 percent increase in exports, whose prices fell by 9 percent, and a 3 percent rise in imports whose prices fell by 3 percent (see Table VII–4).

The rise in exports of services is largely the result of the increase in the export surplus of transport, mostly traffic between foreign ports. Most of the improvement in this category came from shipping, which accounts for 90 percent of total traffic between foreign ports and which rose by roughly 20 percent.

The black market for foreign currency is at its most conspicuous in exports of tourist services. Whereas the number of tourists increased by 5 percent and the balance-of-payments figures indicate that receipts rose slightly, bank statistics show a decline in receipts, a good part of it due to the fact that foreign exchange handled by tourists and suppliers of tourist services bypassed the banking system. This appears to have started in the last quarter of 1983; it is estimated that some $300 million were involved in 1984.

A similar problem is reflected in imports of tourist services. The banks could not very well distinguish between foreign currency purchased for foreign travel and that purchased for hoarding. Nevertheless, although purchases were lower than in 1983, the amount ostensibly acquired for foreign travel was very large. It was not until the end of 1984, when the regulations were tightened, that there was any reduction. Furthermore, in the last quarter of 1984, when the foreign travel allowance was reduced to $1,000, there were signs that the public used its cash balances to finance foreign travel. In any event a 6 percent drop in tourist service imports was recorded in the balance of payments, which is consistent with the fall in private consumption, specifically with the decline in consumer imports.

3. Financing the Balance of Payments

The financing problems encountered this year contrasted with the contraction of the import surplus and with the improvement of the balance of payments on current account, a contrast that illustrates the fact that the degree of public confidence in the stability of the capital market and in macro-economic policy affects the financing of the balance of payments more than it does the import surplus.

It is important to distinguish between long-standing balance-of-payments problems and more transient ones causing only temporary disturbances. Since 1973, deficits continued to accumulate while growth was at a standstill and inflation gathered momentum; this both strained confidence in the country's external position and increased the resort to short-term credit. The latter, which reached a peak in 1982–83, altered the composition of the debt for the worse (Table VII–8); and in spite of the 1984 decline in import surplus, it was still too large to be covered entirely by stable resources (see Table VII–6). There were also

Table VII-5

BALANCE OF PAYMENTS OF THE PRIVATE SECTOR, 1983–84[a]

($ million)

	1983	1984				
		Total	I	II	III	IV
Goods and services account	-3,419	-2,459	-531	-704	-936	-289
Unilateral transfers	945	758	204	179	171	204
Current account	-2,474	-1,701	-327	-525	-765	-85
Long and medium term capital movements[b]	961	44	9	-70	58	47
Basic account[c]	-1,513	-1,657	-318	-595	-707	-38
Short-term capital movements[b]	112	-146	-5	246	-197	-189
Capital movements of banks on behalf of private sector	228	-101	-225	48	60	-89
Errors and omissions[d]	-436	-419	130	-152	-383	92
Effect of private sector on foreign reserves						
Total	1,608	2,323	418	453	1,228	224
Excl. foreign residents' deposits	1,588	2,000	387	504	892	217

[a] Figures may not add owing to rounding.
[b] Nonbanking private sector.
[c] Item 5 (private sector) in Table VII-2.
[d] E&O attributed to private sector (Bank of Israel calculations).

SOURCE: Based on data of the Central Bureau of Statistics, except for the last two lines, based on the Bank of Israel's balance sheet.

more transient shocks which induced speculative hoarding of foreign currency and thus helped to draw down reserves in mid-year.

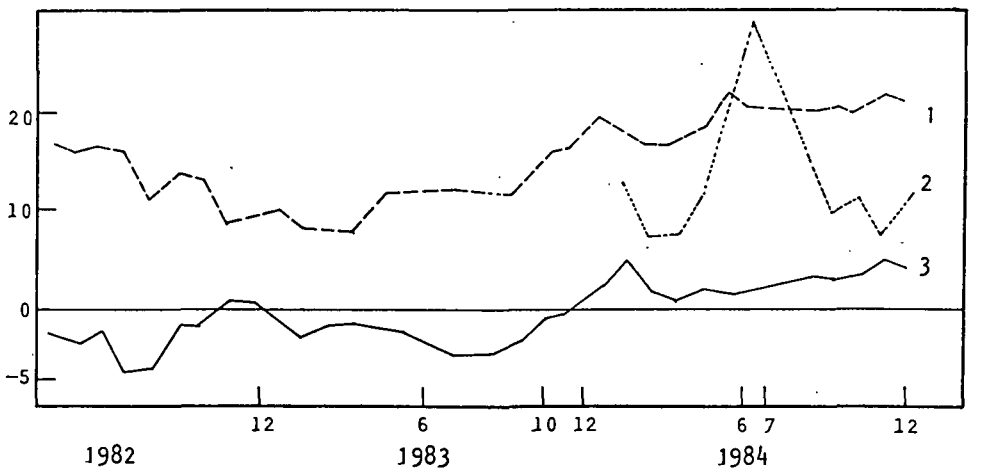
Hoarding is a classical hedge at times of deteriorating confidence, the public being prepared to forgo interest and run the other risks of holding financial assets outside the banking system. In 1984 it was expressed in exceptionally large withdrawals of foreign currency from the official reserves,[13] which, at least, in part, leaked into the black market (mainly via tourist services). Private transfers to abroad rose (in 1983 as well as 1984), while foreign residents' deposits dropped slightly. At the end of 1983 the chief inducement to hoard was the steep increase in the domestic public debt and expectations of devaluation, whereas the hoarding of 1984 ($1–2 billion in June–September) was due to fears of tighter exchange control. Immediately after the elections new measures were introduced, foreign currency purchases fell off, and there were signs that private holdings were being reduced. The steep rise in the black market (relative to the representative) rate

[13] Foreign currency purchases came to $2 billion in 1984, compared with $1.6 billion in 1983 and one third of that in 1982 (Table VII-5). About 45 percent of the 1984 purchases were concentrated in June–July, compared with only 18 percent in June–July 1983.

Figure VII-5

INTEREST RATE DIFFERENTIALS, ISRAEL AND ABROAD, 1982–84[a]

(Percent)



[a] Curve 1: interest on foreign currency loans in Israel *less* the Eurorate; curve 2: yield to maturity of government bonds and (in 1984) of shares covered by the Bank-Share Arrangement *less* the Eurorate; curve 3: black-market premium on representative dollar exchange rate.

just before the elections also indicates that the shock was temporary and connected with the elections (see Figure VII-5).

In retrospect, the balance of payments was financed without an exchange crisis. This was largely due to substantial aid from the U.S. government, which declared that it would back Israel and was willing to help if the balance-of-payments situation deteriorated. The aid conditions were improved (larger aid and all of it as grants in the American fiscal year 1985); however, this does not affect the 1984 balance of payments, since previously approved loans were being used up this year. In the next few years the better conditions will undoubtedly help to finance the current balance of payments and to stabilize the net foreign debt. In 1984 payment of the grant was advanced, as in 1983.[14] However, concentration of the grant at the end of the calendar year raises the need for bridging between grants. Since the government did not seek short-term bridging loans, reserves were drawn down until the new grant was received, although it

[14] American aid is paid according to American fiscal years which end in September of the stated year. In 1983 the Americans for the first time agreed to make the 1984 aid payments in December 1983 (instead of spreading them over the American fiscal year). The 1985 aid was advanced to November 1, 1984.

Table VII–6

THE CORRECTED BASIC BALANCE OF PAYMENTS, 1980–84

($ million)

	1980	1981	1982	1983	1984
Goods and services account	–3,785	–4,387	–4,803	–5,178	–4,893
Corrected stable financing[a]	3,964	4,375	3,921	4,158	4,758
Corrected basic balance	–179	188	–882	–1,020	–135

[a] Calculated as follows: unilateral transfers *plus* long and medium term capital movements (from Table VII–2) *plus* advances on defense imports (See Table VII–A8). An amount of $ 0.5 billion is deducted from this aggregate in 1983; and $ 455 million unilateral transfers were shifted from 1983 to 1984. See notes 15, 16, and 17.

would have been possible to maintain the average level of reserves with fewer fluctuations.

The decline in reserves must be viewed in terms of the precautionary motive, which is the main reason for holding official reserves. It would therefore have been desirable not to allow the level of official reserves to fall this year (see below). The divergence of reserves from the optimum level and the deterioration in debt structure may have raised the cost of the foreign debt (with higher interest payable on renewal of earlier loans as well as on new loans). All the signs are that it was not difficult to obtain short-term roll-over credit and it follows that it would have been better to reduce the last two years' fluctuations in the reserves. Note that this would not have affected the net foreign debt, since this is determined by the real forces reflected in the deficit on current account.

It may be asked what proportion of the import surplus is, *ex post*, financed by stable resources (defined as resources which do not require renewal in the next year, i.e. unilateral transfers and long and medium term debt). To arrive at this measure, three corrections are required, the first connected with Ministry of Defence advances to American producers,[15] the second with the private sector's long-term capital movements,[16] and the third with the prepayment of economic aid in 1983.[17]

[15] These are recorded on accrual basis in the official statistics and are here converted to cash basis (see Table VII–A8).

[16] The 1983 flows have been corrected downwards by $0.5 billion in order to take account of the fact that they were (at least in part) nonrecurring, being connected with bank-share support (although technically recorded as investment). Nevertheless, there was no repatriation of foreign capital in 1984, so that these funds may well be medium term finance.

[17] The aid of two American fiscal years was received in 1983, since the 1984 grant ($910 million) was recorded in the 1983 balance of payments. In order to take account of the fact that this grant belongs to the economic activity of 1984, half of it was recorded in that year (assuming that some was anticipated in 1983).

Whereas the deficit on the current account is that part of the import surplus which must be financed by increasing the net foreign debt (by borrowing or drawing on the reserves), the basic deficit, which shows the change in the net short-term debt, stresses the liquidity aspects of the foreign debt. Thus this year too short-term capital was needed to finance the import surplus, although less than in the preceding two years, coming to $135 million. This amount is not, of course, equal to actual short-term capital movements.

As can be seen in Table VII–6, the situation has been deteriorating since 1982, and $1.9 billion short-term credit was required in 1982–83.

Unilateral Transfers

In 1984 unilateral transfers conformed to the trend they have followed since 1973, the year of the oil crisis and the Yom Kippur War. There was a steep rise, to $2.2 billion, in 1973, and since then to $3.3 billion in 1982, largely owing to American aid.

The increase in U.S. government aid enabled the country to cover a large proportion of the import surplus. Thus in spite of the exceptionally rapid increase in the 1980s, the deficit on current account remained below 10 percent of GNP, or less than half the import surplus/GNP ratio. In 1984, the current deficit/GNP ratio fell to 1.6 percent. The improvement in U.S. government aid is reflected in several ways: in the last two years an additional $1 billion was received because payment was advanced (see above); the amount of economic aid approved by the U.S. Congress appears to be rising, with an appropriation of $1.2 billion for 1985 compared with $0.8 billion in 1984. Other examples include the redeployment loans following the agreement with Egypt, and a decision in principle to give military grants instead of the previous expensive loans: in American fiscal year 1984, only half of the $1.7 billion military aid was in the form of grants, whereas the grants come to $1.4 billion in 1985 and to $1.8 billion the year after. In addition, at the beginning of 1985 it was proposed to give a special economic grant of $1.5 billion, to be paid in 1985 and 1986. These plans do not affect the balance of payments in 1984 but will do so in the next few years.

Long and Medium Term Capital Movements

Total long and medium capital movements came to $1.1 billion this year, or $1 billion less than last year. This represents a shortfall of $200 million from the trend of the years before 1983. These flows financed 22 percent of the import surplus this year, compared with an average of 29 percent in 1980–82 and 43 percent in 1983.[18]

Table VII–A9 shows that most of the decline in long and medium term capital is ascribable to the nonbanking private sector, with loan receipts ($481

[18] The exceptional 1983 figure was connected with bank share support.

Table VII–7

ASSETS AND LIABILITIES IN FOREIGN CURRENCY, END OF 1980–84[a]

($ million)

	1980	1981	1982	1983	1984
1. Net liabilities[b] (3. – 4. – 5.)	11,640	13,373	15,641	18,270	19,408
2. Gross liabilities[b]	21,825	24,501	28,109	29,670	29,966
3. Liabilities[b]	16,237	18,231	20,916	22,825	23,385
Government	10,962	12,252	13,378	14,789	15,579
Nonbanking private sector	2,487	2,524	2,723	3,159	3,073
Banking system (net)[c]	2,788	3,455	4,815	4,877	4,733
4. Foreign reserves of central institutions	3,526	3,814	4,317	3,780	3,255
5. Exporters' credit to foreigners[d]	1,071	1,043	958	774	721
6. Current liabilities	2,930	3,464	4,058	4,744	4,639
Banking system[e]	903	1,490	2,094	2,444	2,464
Nonbanking private sector[e]	864	899	1,010	1,021	889
Direct government debt[e]	0	0	0	220	164
Debt repayment due the next year[f]	1,163	1,075	954	1,059	1,122
7. Net current liabilities (6. – 4. – 5.)	–1,667	–1,394	–1,217	189	662
Net current debt/net debt (percent)	–14.3	–10.4	7.8	1.0	3.4

[a] Figures may not add owing to rounding.

[b] The net debt (line 1) is the relevant aggregate for economic analysis, since the change in it is identically equal to the current-account deficit (net borrowing from abroad) *less* net foreign investment and exchange-rate differentials on foreign currency assets and liabilities. As defined by the Controller of Foreign Exchange (Bank of Israel), the foreign debt includes the direct gross debt of the government and the nonbanking private sector and the net obligations of the banking system (line 3). The Central Bureau of Statistics defines the gross debt as total foreign currency liabilities (line 2) and the net debt (line 1) as gross debt *less* total foreign currency assets.

[c] Including liabilities on behalf of government.

[d] The series was revised by the Central Bureau of Statistics.

[e] Short term.

[f] Long and medium term.

SOURCE: Based on data of the Central Bureau of Statistics and the Bank of Israel.

million) falling back from the exceptional $879 million of 1983 to the long-run level. Repayment was only marginally affected by the large borrowing of 1983; nevertheless it rose from $333 million to $407 million. Thus the situation—known before 1983—of zero net borrowing occurred again in 1984.

Net foreign investment in Israel was negative this year—in 1983 it rose by $415 million, most of it for bank-share support (see Table VII–A10). This year's $107 million disinvestment consists of repatriation of $117 million net of $10 million repatriated Israeli investment abroad.

Short-Term Capital Movements

In years when liquidity is no problem it is sufficient to look at net short-term movements (as shown in Table VII–2). Since this was not true of 1984 (see below), inflows and outflows must be treated separately. The question is to what extent the economy succeeds in recycling its short-term debt. According to Table VII–A11, this was done successfully. The private sector kept its credit going throughout the year, while the government repaid its end-of-1983 short-term debt at the beginning of the year. The expansion of private sector credit contrasts with the decline of the government's. It would presumably have been better to borrow more rather than to draw on reserves, paying off the debt when large additions to the reserves are in view—temporarily increasing the gross short-term debt is presumably less costly than allowing reserves to run down.

The Banking System[19]

The banking system's net indebtedness to the rest of the world declined by $144 million (see Table VII–2), mainly the result of a $134 million decline in foreign residents' deposits and an increase in Israeli banks' deposits with banks abroad (from $237 million to $485 million).

October 1983 was a turning point for Israel's banking system. From 1974 until the bank-share crash, the banking system's capital movements were an important source of balance-of-payments financing (12.7 percent of the import surplus on average for 1974–83). The background was the expansion of Israeli banks' foreign transactions, including the rapid growth of foreign residents' deposits; these ceased to grow in the last quarter of 1983 and have since levelled off (to $6.5 billion at the end of 1984). Like unilateral transfers and tourist receipts, these deposits are sensitive to what happens in the Israeli capital market and to macro-economic policy, as is borne out by Figure VII–5. This shows that the banks' relative return on nonresident deposits was stable during the period. The difference between the cost of attracting nonresident deposits (well approximated by the Eurorate) and the interest charged to Israeli borrowers of foreign currency loans ranges between 15 and 20 percent. The difference is due chiefly to foreign-currency credit rationing, which creates a rent for the banks. Curves 1 and 2 both show that in 1984 the domestic/foreign interest ratio was higher than in previous years. This may be due to the increased risk of domestic assets.

[19] Only Israeli commercial banks (excluding overseas offices) are included here. The banks' foreign purchases of shares are defined as Israeli investment abroad and are therefore recorded under private sector medium and long term capital movements.

4. The Foreign Debt

Two major questions arise in connection with the foreign debt. The first is to what extent it diverges from the desired path. The second question concerns the composition of the debt by borrower, by lender, and by term. Both issues have implications for the country's reputation in the international capital market, the first, as regards evaluation of its economic condition, the second, as regards its liquidity and ability to recycle the debt, and the price of the debt.

The net foreign debt, which consists of the country's total foreign liabilities *less* its foreign assets, rose to $19.4 billion at the end of 1984, or by 6.2 percent. In the preceding three years it rose at a steady annual rate of 16 percent, and has averaged 13 percent since 1973. This year's increase is the net outcome of a $0.3 billion rise in liabilities and a $0.6 billion decline in assets.[20]

In order to evaluate the long-term development of the debt it is commonly related to GNP, although there are other possibilities.[21] Four main motives for borrowing abroad are commonly cited: (a) the importance of access to the international capital market increases with the economy's openness;[22] (b) borrowing enables the economy to soften external shocks, such as the oil crisis and wars. These two points justify only a temporary increase in the net debt. Long-run increases in the debt can be justified by (c) exploitation of good investment opportunities; and (d) raising consumption in anticipation of growth in the near future. But in this case the debt/GNP ratio should sooner or later stabilize as growth investments bear fruit.

The foreign debt has been growing rapidly since 1973 (Yom Kippur War) but not for any sound economic reasons such as those mentioned. Instead, the rise is due to an underlying disequilibrium of the economy, whose chief causes are the long-run expansion of public sector expenditures and a series of shocks (the oil crisis, the redeployment of airfields and the loss of oilfields following the agreement with Egypt, and the war in the Lebanon). Such shocks can justify no more than a temporary rise in the debt/GNP ratio, so that its persistent

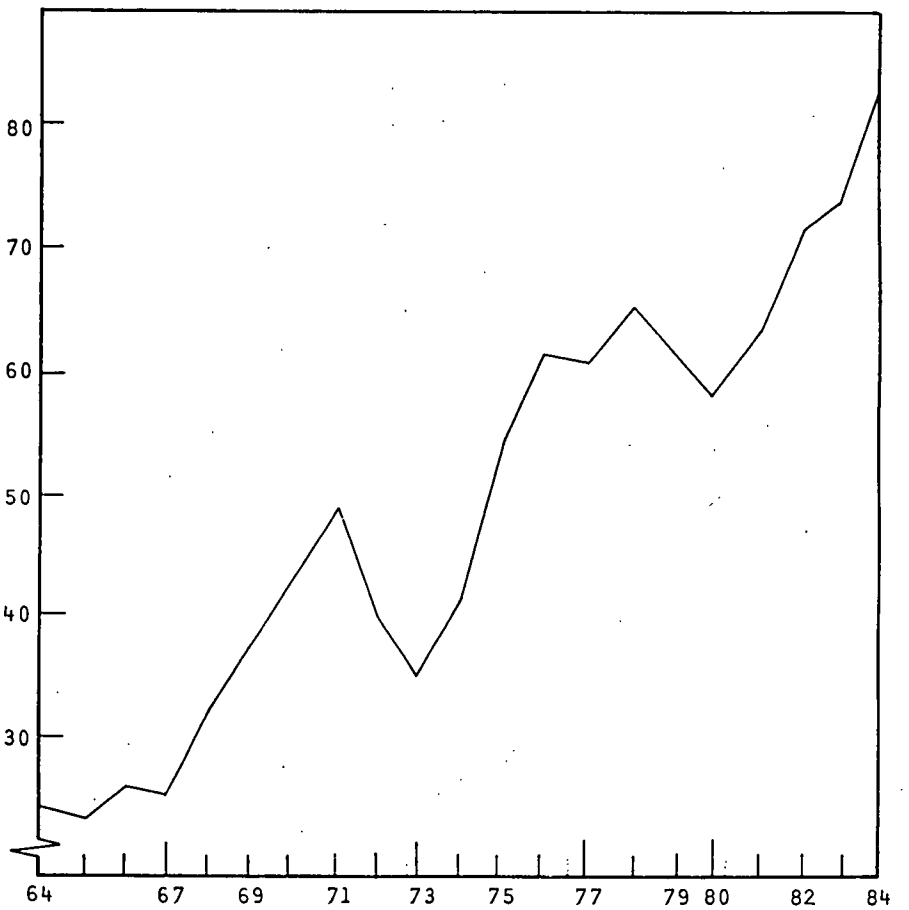
[20] Hoarding of foreign exchange by the private sector biases the foreign debt upwards, since these assets are not captured in the statistics. As defined, the foreign debt should be equal to the sum of current account deficits (since 1952), net of that part of the deficit financed by direct foreign investment (which is of course not defined as part of the debt). This identity does not hold for two reasons: (a) the balance-of-payments data are net of valuation changes for foreign-currency assets and liabilities due to variations in foreign exchange rates; and (b) the official foreign debt statistics do not include unreported assets and liabilities. The indirect estimate (summation of annual deficits) gives a figure of $17.3 billion, or $2.1 billion less than the recorded net debt.

[21] This raises the problem of the unit of measurement. We have here chosen to translate current GNP into dollars at the official exchange rate (quarterly calculation).

[22] An example of this is the fact that suppliers credit rose by 45 percent in 1979–84.

Figure VII–6

NET FOREIGN DEBT AS PERCENT OF GNP, 1964–84[a]



[a] GNP converted to dollars at official exchange rate.

SOURCE: Central Bureau of Statistics.

rise is a divergence from the optimum path. In 1982–83, it was the availability of capital imports that made possible the large increase in the debt.[23]

Composition of the Debt

It is commonly held that in the long run the larger the share of the public sector, the smaller the share of the international banking system, and that the further off the date of repayment, the better it is for the borrower. As will be

23 In 1982 there was an exceptional increase in foreign residents' deposits, and in 1983 the inflow of long and medium term capital was exceptionally high.

seen, Israel's debt structure differs from that of other countries. The principal (net) borrower is the public sector (63 percent of the net debt at the end of 1984). Unlike other debtor countries, most (56 percent) of the net debt is owed to foreign governments (chiefly the United States) and international institutions, and most of it is for relatively long terms. Moreover, the long and medium term debt has throughout exceeded the net debt, since the country's foreign assets are all highly liquid and exceed the gross short-term debt.[24]

The advantageous structure of Israel's foreign debt is evident from an international comparison. The public sector's share has remained high (indeed it rose in 1984); but as can be seen from Table VII–8, the structure of the debt has been deteriorating since the beginning of the decade according to the other

Table VII–8

THE STRUCTURE OF THE NET FOREIGN DEBT, END OF 1982–84

(Percent of total net debt)

	1980	1981	1982	1983	1984
By borrower					
Public sector[a]	64	63	58	60	63
Private sector	36	37	42	40	37
Nonbanking private sector	12	11	11	13	12
Banking system	24	26	31	27	25
Total	100	100	100	100	100
By lender					
Foreign public sector[b]	69	64	60	56	56
Foreign nonbanking private sector[c]	49	53	56	54	52
Banking system abroad[d]	–18	–17	–17	–10	–8
Total	100	100	100	100	100
By term[e]					
Long and medium	114	110	108	99	97
Short	14	–10	–8	1	3
Total	100	100	100	100	100

[a] Government and Bank of Israel.

[b] Foreign governments and international institutions.

[c] Consists mostly of foreign residents' deposits and State of Israel Bonds.

[d] Comprises the country's foreign reserves and loans to Israelis by foreign banks and overseas offices of Israeli banks.

[e] Short-term debt—repayment within one year; long and medium term, all the rest.

SOURCE: Based on data of the Central Bureau of Statistics.

[24] However, the current debt (short-term debt *plus* repayment of principal on long and medium term debt due within a year) has now exceeded assets for the second year running (see lines 6 and 7 in Table VII–7).

two criteria. Thus net Israeli assets with foreign banks have declined from 18 percent of the net debt at the end of 1980 to 8 percent at the end of 1984. The short-term asset surplus (14 percent at the end of 1980) had turned negative by 1984 (net short-term liabilities of 3 percent of the debt). These are gradual changes, and evidently signal a basic shift in the debt structure.

The 1984 decline in Israeli assets held in foreign banks diverged from the long-run trend—the decline in Bank of Israel reserves (the chief asset held with banks abroad) is, at least in part, temporary. The decline in the share of long-term net debt reflects mainly the decline in reserves.

The Country's Liquidity Position

This is not a clearcut concept. A decline in the reserves of a country that is increasing its foreign debt is generally regarded as a deterioration of its liquidity position. The fact remains, however, that the country's business went on as usual in 1984, and there was no sudden liquidity shortage.[25] It follows that the fluctuation of the central bank's reserves (down by $1,371 million in February–October and up by $577 million by the end of the year) did more than merely cause a loss of interest due to speculative hoarding of foreign currency; there was also the indirect effect of worsening the country's credit terms. The deterioration of the liquidity position is also reflected in the rise in the net current debt (to $662 million).

The optimum level of reserves is an increasing function of the size of the gross debt, the volume of transactions with the rest of the world, and the variability of receipts and payments in foreign currency. The gross debt rose by $0.3 billion in 1984, the volume of trade (imports and exports) rose by 3.7 percent, and variability of flows increased because of the public's speculative behavior and the bunching of aid (see above). This means a higher optimum level of reserves, and if reserves were satisfactory at the beginning of the year the trend during the year was in the 'wrong' direction. Another indicator, the number of import months covered by the reserves, also show that reserves were sub-optimal in 1984 (particularly in the third quarter), with a decline from 3 months in 1983 to 2.4 in 1984, compared with an average of 3.3 months in 1980–83. Short-term borrowing to shore up the reserves is obviously expensive, but as pointed out earlier, in the country's present condition a steep decline in reserves is presumably the more damaging.

25 During the year there was frequent concern about the 'net' reserves dropping below the 'red line'. Neither the red line nor net reserves have any economic meaning, since a debtor country has only gross reserves. Such concepts can only be harmful—they constitute a misleading signal and might give rise to a chain reaction on the part of the public—at home and abroad—and the government.

The Foreign Debt Burden

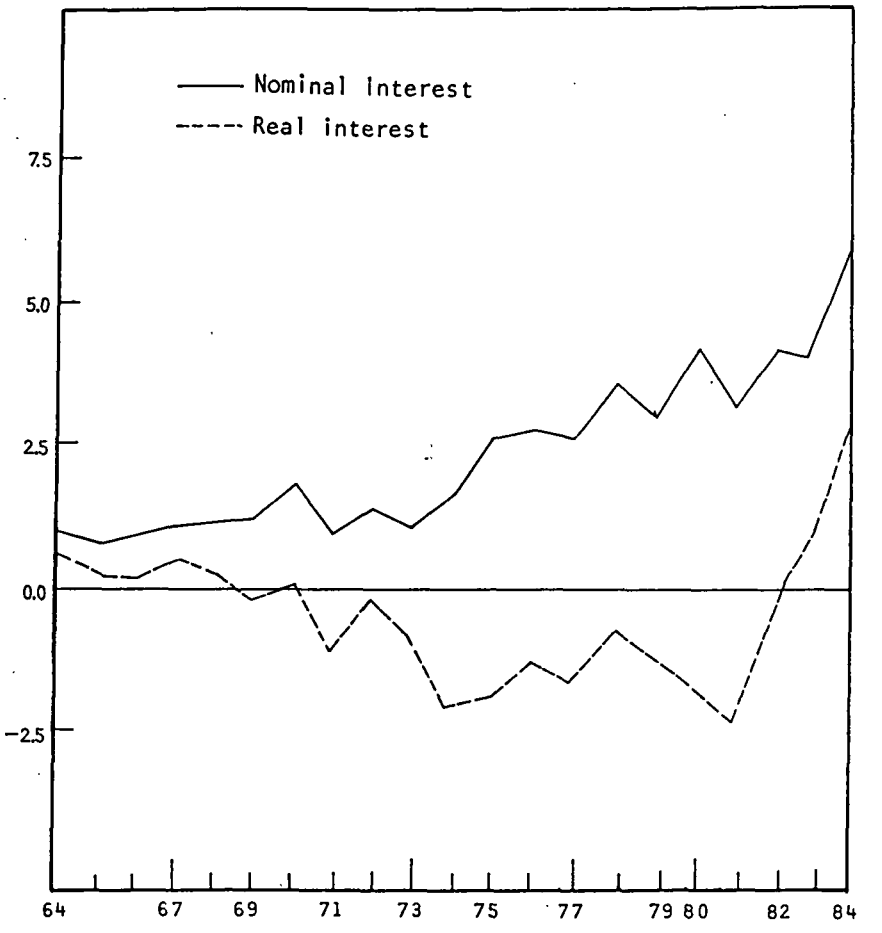
For many years, a good part of Israel's activities has been financed by foreign borrowing. In addition to the concern over liquidity, the country must pay for these capital services.

The real cost of capital services rose in 1984. Thus the ratio of interest to net available resources (see note d to Table VII–9) rose from 4.1 percent in 1983 to 6.4 percent. This is all the more striking in view of the decline in the

Figure VII–7

NET INTEREST ON THE FOREIGN DEBT, 1964–84

(Percent of net available resources[a])



[a] See note d to Table VII–9.

SOURCE: Table VII–9 and underlying worksheets.

3-month Eurorate from 13.1 percent in 1979–83 to 11 percent in 1984. In 1979–83, net interest payments to the rest of the world rose to 4 percent of net available resources. In the last few years, particularly in the last three, inflation has slowed down in the industrial countries and this reduces the implicit gain from erosion of the debt. In earlier years, this gain was reflected in negative real interest. In the last few years real interest has been positive (see Figure VII–7).

This development is yet another expression of the lack of balance between the country's foreign debt and its long-run ability to carry the increasing burden when GNP fails to grow. The increase in net interest payments and in the ratio of debt servicing to exports—and in a good export year at that—should suggest to the policymakers that foreign-currency control, accelerated devaluation, and even satisfactory export growth are not enough to restore the country's external equilibrium. They are no substitute for a public and private saving policy aimed at altering the composition of resource use so as to reduce the import surplus in the long run.

Table VII–9

INDICATORS OF THE FOREIGN DEBT BURDEN, 1979–84[a]

	1979	1980	1981	1982	1983	1984
$ million						
Interest on gross debt	1,232	1,797	2,221	2,633	2,500	2,844
less Interest receipts	632	843	1,450	1,617	1,386	1,176
Interest on net debt	600	954	770	1,016	1,114	1,668
Other capital services						
Debit	146	169	115	138	166	143
less Credit	175	209	34	38	22	18
Repayment of principal	1,063	958	1,163	1,075	954	1,059
Total net debt servicing	1,635	1,872	2,014	2,190	2,212	2,851
Percent						
Interest/net debt[b]	6.3	8.4	6.1	7.2	6.7	8.7
Real interest[c]/net debt[b]	–2.2	–2.9	–3.8	–0.7	1.4	3.7
Interest/net available resources[d]	3.0	4.2	3.2	4.1	4.0	6.4
Net interest/exports[e]	8	11	9	12	13	18
Net debt servicing as per cent of						
Exports[e]	23	21	23	26	26	31
Exports[e] + unilateral transfers	16	16	17	20	19	23
GNP	10	9	9	10	9	13

[a] Figures may not add owing to rounding.
[b] Calculated with debt lagged six months.
[c] Deflated by five-year moving average of CPI for industrial countries (*IFS*).
[d] GNP *plus* unilateral transfers.
[e] Exports f.o.b., excluding capital services.

SOURCE: Based on data of the Central Bureau of Statistics.

Net imports of capital services rose by $0.5 billion to $1.8 billion in 1984. This is an increase in the average rate of interest from 6.7 to 8.7 percent, and it stems from, on the one hand, the rise in the gross debt and the decline in assets, and, on the other, from the continued replacement of old loans by new, more expensive ones.

Interest receipts declined by $169 million (banking system) and by $42 million (Bank of Israel). The assets of Israeli banks (including the Bank of Israel) dropped by an average of $1 billion from September 1983 to September 1984,[26] a decline that cannot explain more than half of the $210 million fall in interest receipts (assuming the Eurorate). Moreover, the Bank of Israel's assets fell by more than the commercial banks', so that the breakdown of the decrease in interest receipts is also difficult to explain: a good part of the foreign currency purchased from the Bank of Israel was hoarded, with a consequent loss in interest, and one would have expected the central bank's interest receipts to decline by more.

It is easier to explain the rise in interest payments. The average gross debt (calculated as for assets) rose by $1.4 billion. Assuming a marginal interest rate of 11½ percent, this increase directly added $160 million interest. Recycling the short-term debt and some longer-term loans bearing floating Euro interest further added to the cost, since the Eurorate rose from 9.6 to 10.8 percent on average.

[26] The lag of one quarter assumes that this is the average term of deposit of the reserves.