CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

THE EXPANSION of the national product slowed down in 1970, after full employment was reached and all reserves of idle factors of production, which had made possible the accelerated growth of the two preceding years, were fully tapped. After advancing 14.5 percent in 1968 and 9.5 percent in 1969, real gross GNP went up by 7 percent in 1970. Economic activity expanded at more or less the same rate as productive capacity. The latter grew rather more slowly than in the full employment conditions of the early 1960s, mainly because of a much smaller percentage increase in the labor force. GNP per employed moved up by 5 percent, a rate similar to that of other years of full factor utilization.

Under these conditions of full employment and slower GNP growth, public consumption and export demand accelerated in 1970, but without upsetting the economy's internal stability or generating demand-inflationary pressures. This can be attributed to two principal factors: (1) a large part of the additional public consumption consisted of imports of defense goods; and (2) the fiscal measures introduced in 1970 held private consumption growth to 3 percent—much less than the growth of the national product. Civilian public consumption also rose by a moderate 3 percent, while capital spending by the public sector and its companies on infrastructure and public services was cut back. On the other hand, direct measures were adopted to stimulate exports and restrain imports. These developments released economic resources for those uses whose growth accelerated—defense, exports, and public housing construction for immigrants—and averted the buildup of demand pressure.

It therefore appears that, as a result of the policy followed, the growth of demand was not in itself a factor driving up prices. The rapid increase in prices that occurred in 1970 must be ascribed to the raising of indirect taxes and reduction of subsidies, which were an integral part of the Government's policy of restraining private consumption, and to other cost factors. To be sure, the balance of payments deficit on current account was much higher in 1970, but since this was largely due to heavier defense imports—which are not influenced by internal economic forces—it was not indicative of the existence of demand pressures. Moreover, an adverse development in the terms of trade (which likewise are not affected by internal economic forces), because of the decline in diamond and citrus prices, resulted in a particularly heavy loss in 1970. If the increase in direct defense imports and the terms-of-trade loss are excluded, the

Table I-1

MAIN ECONOMIC INDICATORS, 1966–70

(percentages)

	Annual increase or decrease (–)						
	Average 1961–65	1966	1967	1968	1969	1970	Average 1966–70
Resources and uses							
(at constant prices)							
Total domestic uses	10.5	–0.8	3.7	16.6	13.1	10.1	8.5
Gross national product	10.2	1.1	2.2	14.6	9.3	6.9	6.8
GNP per capita	6.1	–1.5	–1.0	10.8	6.5	4.1	3.8
Private consumption	10.3	3.1	1.4	12.0	10.8	3.0	6.1
Private consumption per capita	6.1	0.5	–1.7	8.3	8.0	0.3	3.1
Public consumption	10.6	8.3	36.1	8.9	16.1	26.3	19.1
Gross investment	11.3	–16.1	–22.0	48.2	15.6	8.8	6.9
Balance of payments,[a] excl. trade with the administered areas							
(in dollars)							
Imports	12.0	3.8	10.6	24.4	20.7	20.2	15.9
Exports	15.6	16.6	6.6	21.7	11.7	8.3	13.0
Import surplus	8.8	–14.4	18.4	29.0	35.6	36.8	21.1
External debt	13.7	7.7	17.8	22.2	11.6	23.4	16.5
Foreign exchange reserves[b]	27.7	–3.5	13.8	–7.2	–46.1	7.2	–7.2
Population and employment							
Average population	3.9	2.6	3.2	3.4	2.6	2.7	2.9
Number of employed	4.8	–0.6	–4.3	9.0	3.8	1.8	1.9
Daily average of unemployed	–11.0[c]	126.8	58.0	–56.3	–54.5	–29.7	8.9
Prices and national income							
(nominal)							
Average monthly wages per employee[d]	13.6	19.1	0.2	3.2	5.2	9.1	7.4
Wages per man-hour[d]	13.3	19.8	3.3	–0.3	3.7	10.2	7.3
GNP prices	8.0	8.8	1.9	2.3	3.5	8.7	5.0
Consumer price index (annual average)	7.4	8.0	1.6	2.1	2.5	6.1	4.1
National income	18.8	9.0	4.1	18.8	12.7	15.1	11.9
National income per capita	14.3	6.2	0.9	14.9	9.8	12.1	8.8
Finance							
Money supply (annual average)	17.6	7.3	20.3	19.0	7.1	5.0	11.8
Bank credit to the public and bill brokerage credit (annual average)[e]	19.6	22.9	19.0	12.4	19.7	17.3	18.3

[a] Goods and services; imports c.i.f., exports f.o.b.
[b] Foreign currency balances in the Bank of Israel at the end of the year.
[c] In 1963–65 only.
[d] Since 1969 a new series based on National Insurance Institute data, which include East Jerusalem.
[e] In 1961–63 bank credit only.

import surplus did not grow at all. This constituted a notable change in the trend of the last few years. Only part of this improvement can be attributed to the reduction of imports following an upsurge at the end of 1969 in anticipation of a rise in import prices.

Nevertheless, it must be stressed that the size of the current deficit—$ 1,260 million in 1970, compared with $ 920 million the year before—remains the most pressing problem facing the economy because of the growing difficulty of financing a deficit of such dimensions. Despite the rapid growth of unilateral foreign receipts since the Six Day War, their share in financing the deficit has been declining, a fact reflected in the huge increase in the country's external debt and, along with it, in the burden of servicing the debt. In 1970 foreign liabilities shot up by $ 500 million and stood at $ 2,620 million at year's end. Interest payments alone are estimated at $ 180 million for 1971.

The modest 3 percent increase in private consumption (compared with 11 percent in 1969) represents a per capita rise of only 0.5 percent. In view of the growth of the national product, private income from economic activity, and especially the enormously larger volume of private transfers from abroad, this constituted an impressive turnabout. The standard of living failed to rise during the 1966–67 recession as well, but that was against a background of unemployment and a standstill in private incomes. The 1970 turning point in private consumption was due to the imposition of stiff taxes and nonnegotiable compulsory loans, as a result of which real per capita private disposable income (net of the loans) edged down 1 percent,[1] after rising by approximately 8 percent in 1969. In other words, the additional taxes and compulsory loans prevented the public from increasing private consumption to the same extent as the growth of the national product and income, as happened in previous years. In 1969 purchases of consumer durables were stepped up in anticipation of a price rise, and this helped to restrain private consumption in the year reviewed. As a result of these developments, the share of private consumption in incremental resource use (excluding direct defense imports) fell from 44 percent in 1969 to 21 percent.

Civilian public consumption also grew by only 3 percent, and its weight in resource use declined. By contrast, there was a 40 percent jump in defense spending, and this brought up the weight of public consumption in total uses. Defense outlays absorbed more than half of the incremental resources in 1970, a fact which had far-reaching repercussions on both internal economic developments and the balance of payments.

Gross investment, which had expanded strongly in the two preceding years,

[1] Gross nominal private income from domestic sources grew by 15.4 percent, and more than half of this was absorbed by the additional taxes and compulsory loans. In other words, disposable income went up about 7.5 percent, and net of the price increase of some 6 percent, the real growth in private disposable income from domestic sources came to roughly 1.5 percent, a decline of 1 percent in per capita terms.

slowed down in 1970, when the rise amounted to 9 percent—i.e. a little more than the growth of the national product. Dwelling investment continued upward at a vigorous rate, by 33 percent, but nondwelling investment tapered off.

Capital spending by the public sector and its companies was down 20 percent, but private investment continued upward, particularly in industry, private services, and shipping. The cutback in public sector investment constituted an integral part of the Government's policy of curbing demand, but it was also connected with the completion of several large projects.

As a result of these developments, the nondwelling capital stock rose by 8 percent, the number of Israeli employed by 2 percent, and GNP per employed by about 5 percent, which is similar to the normal growth rate in the past. The output of industry and the transportation and communications sector expanded by more than the average rate of 7 percent, while the output of agriculture and apparently some service branches moved up at a below-average rate.

The labor force participation rate declined for the fourth year running, apparently because of the larger percentage of the working-age population serving in the armed forces or continuing their education. With unemployment at an end, the number of Israeli employed rose by only 2 percent; the total employed labor force, including workers from the administered areas, expanded by 3 percent, with the areas accounting for a third of the increment. In 1970 wages per man-hour went up by 10 percent, after three years of mild increases. Total labor costs per man-hour were up 14 percent because of a jump in fringe benefits, in particular National Insurance contributions by employers. Most of the 1970 wage increases were within the framework of the new collective agreements (the tripartite "package deal"). As in 1969, wages went up at a faster-than-average rate in industry and construction, sectors which enjoyed a relatively strong growth of demand.

After holding fairly steady for three years, prices moved up in 1970. The consumer price index rose by 10 percent during the year, or by 6 percent on an annual average. Other price indexes reveal a similar picture. This change was connected chiefly with cost factors, and with a few exceptions, there does not appear to have been any demand pressure. Most of the price increase took place within a relatively brief period after August, following the raising of indirect taxes that month, in particular the imposition of a 20 percent surcharge on imports (except for several essential consumer goods) and the reduction of subsidies on a long list of products. Until August prices had drifted upward at a rather modest pace, and apart from February, the consumer price index (excluding fruit and vegetables and housing) went up at about the same rate as in the corresponding months of 1969. Other factors driving up prices were the indirect tax hikes in February, the accelerated rise of labor costs, and higher foreign import prices. Above-average price increases were recorded in investment goods and in several commodities with a high import component, as well as in items such as housing where there was demand pressure. Prices of controlfree services also moved up rapidly, apparently under the influence of the generally inflationary climate and the desire of the suppliers of these services to maintain their real disposable income in the face of increased taxes, forced loans, and higher prices.

The more sluggish expansion of economic activity and the advancing of purchases of foreign goods in 1969 in anticipation of a price rise were reflected in a much slower growth of civilian imports—8 percent as against 19 percent in 1969. In real terms the deceleration was even more striking: after adjusting for the increase in international prices, these imports were up only 5 percent, less than the growth of the national product. Altogether, imports of goods and services at current prices rose by 20 percent to reach $ 2,630 million; but the much greater volume of defense imports (up $ 290 million) accounted for two-thirds of the increment. The growth of commodity imports came to 9 percent. Final consumer goods edged down 1 percent, because of a decrease in durables. Imports of current inputs rose by a mild 6 percent, owing partly to a decline in rough diamonds, while other industrial inputs went up 13 percent, or 10 percent in quantitative terms—a little less than industrial output. In capital goods there was an appreciable increase in ships and aircraft. In services the most striking rise was in defense imports; other services went up by only 7 percent as against 18 percent in 1969. Foreign travel was down sharply after a big increase in the two preceding years.

Total export receipts rose by 8 percent in 1970, compared with 12 percent the year before, and totalled $ 1,370 million. The smaller increase was due primarily to the much weaker demand for the two leading items, citrus and diamonds. In quantitative terms, exports of goods and services advanced 7 percent, more or less the same as in 1969. The value of commodity exports other than citrus and diamonds increased by 17 percent (the same rate as in 1969). The impressive gain scored by these exports in the past few years reflects the cumulative rise in export profitability and the maturing of investments in export industries. Changes in the composition of overseas commodity sales in 1970 resulted in the value-added component of total commodity exports increasing faster than in 1969.

A striking development in export is its changing composition: the share of the major traditional items is falling, while that of a long list of other agricultural and industrial products is mounting; in the last two years the latter accounted for most of the export increment.

As a result of these developments in imports and exports, the adverse balance on goods and services account widened by $ 340 million, from $ 920 million in 1969 to $ 1,260 million (excluding trade with the administered areas). About $ 290 million of the increase consisted of direct defense imports, and another $ 70 million may be ascribed to the worsening of the terms of trade. The Government's efforts to stimulate exports and reduce imports by changing their relative domestic prices in August are only partly reflected in the 1970 figures.

Together with the increase in the import surplus, capital imports shot up from $ 675 million in 1969 to more than $ 1,300 million in the year surveyed. Although unilateral transfers rose from some $ 300 million per annum in 1965–66 to $ 480 million in 1969 and $ 660 million in 1970, their weight in total capital imports dropped from approximately 65 percent in the four years before 1967 to 52 percent in 1970; to finance the year's import surplus another $ 600 million in loans had to be raised. The combined effect of the changes in the import surplus, capital imports, and short-term capital movements was a $ 25 million growth in net foreign exchange reserves in the Bank of Israel, following a steep drop in 1969.

The money supply expanded by 14 percent during 1970, compared with only 2.5 percent the year before. This acceleration occurred in a year when stringent monetary and fiscal measures to reduce liquidity in the economy were introduced. In 1969 no policy of actively absorbing liquidity had been pursued, but the mild monetary expansion that year could be attributed to the drawing-down of foreign currency reserves. In 1970 this factor no longer applied, and this accounts for the main difference in the development of the money supply in these two years. In 1970 the increase in Bank of Israel credit to the Government and the public was not offset by a decline in foreign currency balances, and liquid asset holdings of banking institutions swelled by IL 230 million, enabling them to extend a much larger volume of credit to the public.

Although the money supply moved up rapidly in the course of the year, the average annual rise was small—approximately 5 percent, compared with 7 percent in 1969. The upward trend grew stronger in the second half of 1970, and the moderate increase in the average figure largely reflects the relative stability in 1969. The percentage rise in the average annual level fell below that of real GNP, and if account is taken of the price increases due to the raising of taxes and the cancellation of a number of subsidies, the restraining effect of the limited growth in the average level of the money supply on aggregate demand stands out all the more. However, the comparatively high level reached by the money supply at the end of 1970 threatens to engender demand-inflationary pressures in the future.

Other financial assets held by the public (less liquid deposits and the Government Short-Term Loan) expanded a little faster than in 1969, while total bank credit to the public (including rediscounts by the Bank of Israel) went up at about the same rate in both years.

A major monetary event of 1970 was the abolition of the interest rate ceiling at the end of March and the imposition of liquidity requirements on bill brokerage. As a result, the bill brokerage market virtually disappeared within a few months, together with the distortions it had created in the banking system for many years. Most of the funds invested in this market were shifted to ordinary time deposits. These changes also enhanced the effectiveness of the monetary-policy instruments. The abolition of the interest ceiling led to the unification of interest rates without disrupting the money market. Interest on export credit and other directed credit within the framework of liquidity exemptions did not change, but that on ordinary bank credit rose; the free interest rate settled at a higher level than the previous official ceiling rate but below the rate that had prevailed in the bill brokerage market. Interest on time deposits went up together with that on ordinary bank credit. Besides the extension of the liquidity regulations to bill brokerage, several other restrictive monetary measures were adopted, including the imposition of obligatory import deposits, increased sales of the Short-Term Loan in the open market, a changeover from local to foreign currency credits for financing export shipments, and a marked slowdown in the Bank of Israel's rediscounting operations.

In 1970, as already mentioned, new fiscal measures designed to damp down aggregate demand were introduced. To be sure, the consumption and demand surplus of the public sector rose considerably; but the increase in the demand surplus stemmed from the growth of the sector's direct foreign expenditures, especially on defense imports, while the excess of domestic expenditures over revenue declined. The higher rates of taxation and the imposition of heavier compulsory loans boosted the Government's receipts from these two sources by an appreciable 31.5 percent, or IL 1,620 million in absolute terms. This exceeded the increase in domestic expenditures, so that the net result was to reduce domestic demand. The public sector's demand surplus plus its net credit to the public (excluding transactions with the banking system) represents the total liquidity injected by the sector into the economy; this came to IL 600 million in 1970, less than in either of the two preceding years.

Despite the much larger revenue from taxes and compulsory loans, the public sector had to rely more heavily on foreign financing in 1970 because of the enormous increase in defense imports. The total amount required to cover the sector's demand surplus and net credit flow to the rest of the economy was IL 3,460 million, compared with IL 2,650 million in 1969. Unilateral transfers and net foreign credit were, at IL 2,340 million, double the previous year's figure, while bank credit to the public sector dropped to IL 1,120 million—of which IL 890 million was from the Bank of Israel (compared with IL 1,250 million in 1969). Owing to the much heavier defense spending, the public sector dissaved more in the year reviewed. As a result, the small 1969 gross national saving of IL 300 million out of GNP vanished completely, although private saving went up. However, the propensity of the private sector to save voluntarily apparently diminished somewhat. The rate of saving out of gross disposable income from domestic sources (excluding the compulsory loans) declined by about 2 percent. But if the compulsory loans levied in 1970 are treated as saving (and not a tax), this will bring up the saving rate by one percentage point, from 21 to 22 percent.

In view of the enormous security requirements in 1970, when the economy reached a state of full employment, the constraints imposed by the limited quantity of available resources grew more acute. Incremental resources diverted to consumption and investment amounted to IL 2,140 million at constant prices, while the real gross national product rose by only IL 1,230 million. In other words, the import surplus supplied 42 percent of the incremental resources for domestic use. In 1970 the import surplus came to 20.3 percent of total available resources, compared with only 12.5 percent in 1966. This trend cannot continue for long, for it is becoming increasingly hard to finance an import surplus of this magnitude. There is therefore no alternative to cutting the import surplus despite the difficulties due to the heavy defense outlays.

This means that in the future the additional resources derived from the growth of GNP cannot all be allocated to domestic use, as they were in the recent past, but must in part be devoted to reducing the import surplus. Since under present conditions the possibilities of cutting defense expenditures are limited, and since the sustained growth of the economy requires an adequate volume of investment, most of the burden must fall on private consumption and public civilian consumption. The fact that in 1970 the percentage increase in these two uses was held back to well below that in GNP and the encouragement given to exports indicate what can be achieved by persisting consistently with the appropriate economic policies introduced during the year. Developments in early 1971 point to a retreat from the improvement begun in the previous year, and an effort even greater than that made in 1970 is needed to restore the declining trend in the balance of payments deficit on current account while maintaining rapid economic growth.