CHAPTER VII

THE BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

Israel's balance of payments continued to improve in 1985: the import surplus and the current-account deficit continued to decline, the foreign debt was reduced, and there was no need to rely on short-term net borrowing to finance the deficit. The balance on current account (the difference between unilateral transfers from abroad and the import surplus) improved by $2.5 billion, following $0.7 billion in 1984, and for the first time in 30 years, Israel had a surplus on current account — of $1.1 billion.

This improvement was due to two main factors: (a) an increase of $1.6 billion in U.S. grants, representing in part completion of the shift from loans into grants and in part the special emergency aid of $750 million (the first instalment of a total grant of $1.5 billion). As well as improving the balance of payments directly, the increase in U.S. grants-in-aid also increased confidence in the government, thereby reducing demand for imports and foreign assets. (b) A restrictive macro-economic policy which reduced domestic demand relative to GNP and made it possible to reduce the import surplus, while the relative price of imports and exports rose. Domestic use of resources (excluding direct defense imports) contracted by 3.4 percent, while GDP increased by 2.8 percent.[1] This was reflected in the decline of the civilian import surplus (excluding capital services) from $1.5 billion to $0.3 billion (in 1984, the decline was $1.1 billion). At the same time, the relative price of imports and exports rose by, respectively, 7 and 5 percent.

The big improvement in the current account on the one hand reduced the net foreign debt from $19.7 billion to $19.2 billion, and on the other, it eliminated the need to resort to net short-term financing. The country's foreign liquidity position improved: the net current debt, which stood at $0.7 billion at the end of 1984, was liquidated in 1985, most of the improvement showing up in the foreign reserves, which rose from $3.3 billion tro $3.8 billion. The total net foreign debt was also reduced; net interest payments nevertheless rose from $1.8 billion to $1.9 billion, and some other indicators of the foreign debt burden also continued to rise.

Direct defense imports increased in 1985 and the total import surplus fell from $4.8 billion to $4.0 billion. The volume of exports (excluding capital ser-

[1] At constant prices this change would have reduced the ratio of civilian import surplus (excluding capital services) to GDP by 5.8 percentage points; however, as a result of relative price movements, it declined only from 8.2 to 5.9 percent.

vices) rose by 7 percent, compared with 14 percent in 1984, with a slowdown in industrial products and a rise in tourist services. The decline in export growth was in part due to the sluggish expansion of world trade and the failure of military exports to grow; moreover, the 14 percent rise in 1984 was exceptional. The West European currencies appreciated in the course of 1985; this should have helped Israeli exports, but exports cannot be instantaneously shifted to other markets. The volume of civilian imports (excluding capital services) fell by 6 percent, with imports of final goods and (especially) foreign travel, declining, while imports of intermediates rose.

The year was not all of a piece. The civilian import surplus continued to decline in the first half, but pressure on the sources of balance-of-payments financing persisted as the private sector continued to purchase foreign assets. The events of the second half of the year were shaped by the economic stabilization program, which included measures to lower the profitability of holding imported goods and foreign assets, as well as to reduce real disposable private income and to allay fears that financial assets might be taxed. Against a background of import surplus improvement since 1983 and increased U.S. aid, the public reduced both its foreign and domestic demand (mainly in the third quarter). The decline in domestic demand was supported by a cut in public expenditure. Taken together, these measures reduced GDP and damped down economic activity. Some of the developments were of a temporary nature and a few of them had been neutralized by the end of 1985 or early 1986. Nevertheless, they increased the credibility of the stabilization policy in its early stages and moderated the pressure for devaluation.

The 1985 improvement in the balance of payments continues a process that began in the second half of 1983, after a serious deterioration from 1980 to 1983. In 1981–83, government policy was expansionary, so that domestic demand rose substantially. This failed to stimulate economic growth; instead it was expressed in a rising import surplus, with a decline in the relative price of tradables and a rise in real wages and real labor costs.[2] The rise in import surplus was accompanied by current-account deterioration, leading to a basic deficit (see Figures VII–1 and VII–2). This means that the import surplus had to be financed out of net short-term capital inflow, part of it by drawing down the reserves.

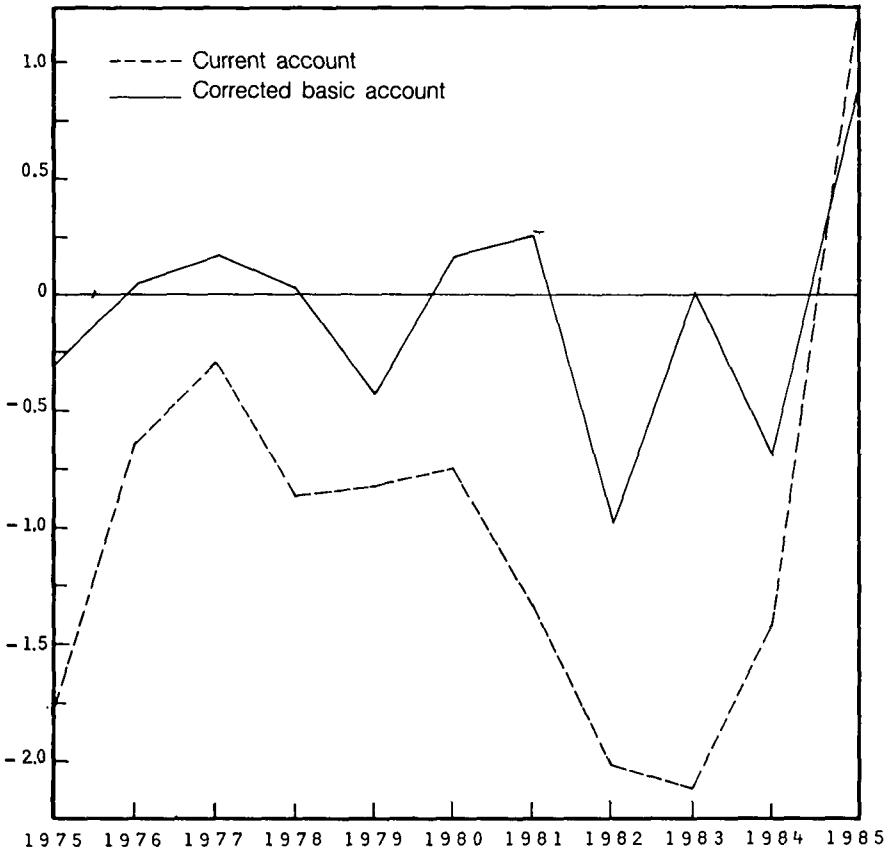
The burdensome legacy of the 1981–83 expansionary policy weighed heavily on the corrective policies adopted in 1984 and 1985, and its effects have not yet been fully overcome. On the one hand, this legacy consisted of a large increase in the foreign debt and the corresponding increase in debt servicing; on the other hand, confidence in the government waned, against a background of large domestic debt, the inconsistency of government policy, and the delay

[2] In this period demand was boosted by several, partly interrelated, processes of varying influence: the expansionary fiscal policy of 1981, the war in the Lebanon, attempts to lower interest rates, the slowing of devaluation and the rate of increase of the prices of goods subject to price control, and finally the repercussions, until October 1983, of bank-share regulation.

Figure VII-1

CURRENT AND BASIC (CORRECTED) BALANCE OF PAYMENTS, 1975–85

($ billion)



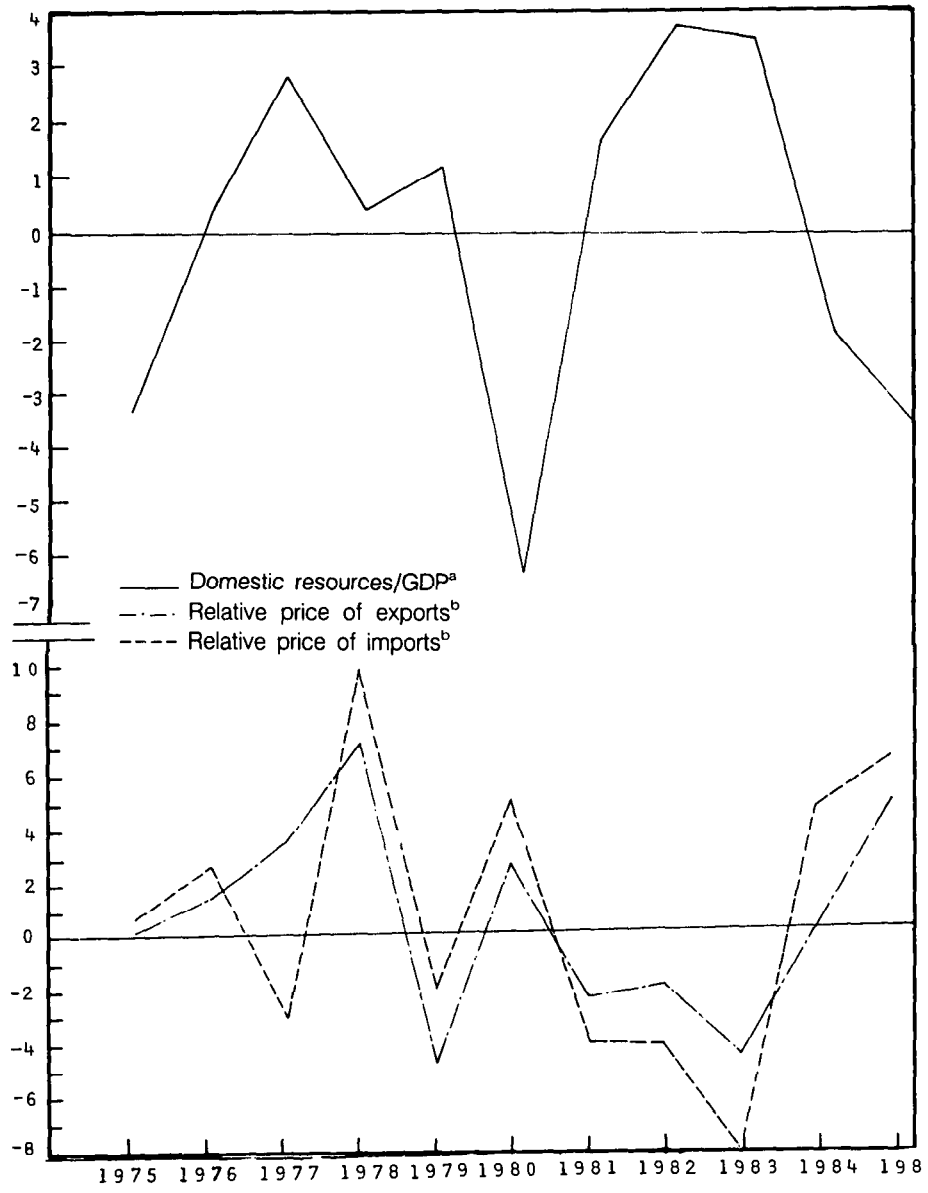
in adopting a comprehensive corrective program, all of which aroused serious fears of taxation of financial assets and administrative restrictions on foreign currency and imports, and induced private capital exports in a variety of forms, including hoarding of foreign currency (some of these capital exports were illegal). The decline in the government's credibility lowered the country's credit standing abroad, with adverse effects on borrowing conditions.

In 1983–85, economic policy was under a constant threat of a run on the foreign reserves. Policy-makers therefore tended to adopt measures designed to reduce the short-term demand for foreign currency, even measures conflicting with long-run considerations or having no lasting effect on the supply of foreign currency. This tendency was reflected in the relatively large devaluations of the summer of 1984 and the period of the first package deal and in the slow reduction of real interest rates under the 1985 stabilization program.

Figure VII-2

RATIO OF DOMESTIC RESOURCE-USE TO GDP AND RELATIVE PRICES OF IMPORTS AND EXPORTS, 1975-85

(percent change over preceding year)



[a] Excluding direct defense imports.

[b] See note d to Table VII-1.

Moreover, foreign-currency controls were tightened at the end of 1983. Currency controls impose a heavy administrative burden on both the private sector and the authorities, reduce economic efficiency, and weaken respect for the law. They may make it difficult to exploit the opportunities opened by the free trade agreement with the United States and the agreements with the EEC, and may hold back the share of international economic activity channelled through multinational corporations — opportunities that can only be fully exploited by flexible management of international transactions.

The 1981–83 deterioration in the balance of payments began with rising domestic demand and an increase in the import surplus, and only later spilled over into the capital account. Similarly, the corrective policies of 1984 and 1985 began by throttling back domestic demand and the import surplus and affected the capital account later. Domestic resource use (excluding direct defense imports) contracted by 9 percent and the GDP rose by 4½ percent from 1983 to 1985, thereby reducing the civilian import surplus (excluding capital services) by a total of $2.4 billion over the period. The total import surplus declined by less ($1 billion) as a result of the increase in net debt servicing and direct defense imports.

Between the end of 1983 and the first half of 1985 the currency was devalued much more rapidly than before. At different times, accelerated devaluation helped to curb speculative demand for foreign currency; in the short run it speeded up the adjustment of relative prices and the production system. Thus it channelled the contraction of domestic demand mainly into the import surplus, moderating the effect on domestic product and employment. However, the main effect of accelerated devaluation was to increase the rate of inflation. As can be seen in Table VII-1, the relative price of imports and exports rose by 12 and 6 percent respectively from 1981 to 1983. It is clear that if demand had not been cut back, this change would not have lasted beyond the short run; it is equally clear that in the absence of accelerated devaluation, the contraction of demand would eventually have adjusted relative prices.[3]

The civilian import surplus (excluding interest payments) which declined sharply in the last quarter of 1984, remained low in the first half of 1985. From the second half of 1984 to the first half of 1985, the decline was $600 million, the combined result of lower domestic resource use and a rise in the GDP (seasonally adjusted, the decline was more moderate). In these six months, the private sector continued to buy foreign currency from the Bank of Israel in amounts substantially exceeding its requirements for financing its cur-

[3] A reduction in aggregate demand affects both tradables (imports, exports, and import substitutes) and nontradables. The first makes it possible to use a higher proportion of locally produced tradables to reduce the import surplus; the contraction of demand for nontradables leads to excess supply, falling prices, and lower output, which releases factors of production for tradables and makes further reduction of the import surplus possible. As a result of various rigidities, the process goes through a transitional phase of reduced output and higher unemployment. Inflationary policy (accelerated devaluation) may shorten the transition by overcoming nominal rigidities but cannot affect all rigidities.

Table VII-1

BALANCE-OF-PAYMENTS INDICATORS, 1980–85

	1980	1981	1982	1983	1984	1985 Jan.–Dec.	1985 Jan.–June	1985 July–Dec.
$ billion								
Current account deficit	0.8	1.3	2.0	2.1	1.4	−1.1	−0.7	−1.8
Corrected basic deficit[a]	−0.2	−0.3	0.9	−0.0	0.7	−0.4	−0.0	−0.4
Net foreign debt	11.6	13.4	15.6	18.3	19.7	19.2	20.4	19.2
Net current foreign debt[b]	−1.7	−1.4	−1.2	0.2	0.7	0.0	1.4	0.0
Foreign reserves[c]	3.5	3.8	4.3	3.8	3.3	3.8	2.6	3.8
Import surplus								
Total	3.8	4.2	4.7	5.0	4.8	4.0	2.2	1.8
Civilian	2.0	2.1	3.1	3.9	3.3	2.1	1.1	1.1
Civilian excl. net capital services	1.1	1.2	2.0	2.6	1.5	0.26	0.14	0.13
Exports excl. capital services	9.0	9.3	8.8	8.9	9.6	10.12	4.97	5.15
Civilian imports excl. capital services	10.2	10.5	10.8	11.6	11.2	10.40	5.12	5.27
Index, 1977 = 100								
World trade (quantity)	113.9	115.1	112.2	114.6	124.7	128.1		
Terms of trade (merchandise excl. diamonds)	93.2	92.0	95.5	96.8	95.5	98.3	98.0	98.4
Relative prices[d]								
Imports	113.1	108.5	103.9	95.4	100.1	106.9	105.1	108.7
Exports	104.8	102.3	100.3	95.7	96.1	101.0	100.8	101.3

[a] See text.
[b] Short-term debt *plus* medium and long term loans due to be repaid within one year.
[c] Held by central monetary authorities.
[d] Relative to domestic use of resources. The calculation excludes direct defense imports.

rent account deficit. Since the private sector could hedge against devaluation by holding domestic financial assets linked to the exchange rate, it seems that these private capital exports indicated that fear of a tax on financial assets persisted.[4]

In the second half of 1985 developments were shaped by the stabilization program (see Chapter I). In the long run, the program is designed to improve the balance of payments in two main ways: (a) by reducing the share of private and public consumption in net available resource (GNP *plus* unilateral transfers), thereby releasing growth resources and permitting further reduction of the foreign debt burden; (b) by returning to price stability, thereby releasing resources previously used to cope with inflation and eliminating the severe distortions caused by inflation; price stability should help to speed up growth, improve the balance of payments, and enhance the country's credit standing abroad.[5] The drastic fall in the inflation rate is largely attributable to the suspension of devaluation against the U.S. dollar.[6] The effects of devaluation on the balance of payments are temporary and it has in the past served as a substitute for an appropriate fiscal policy. The many economic and social advantages of a return to price stability therefore justified giving up devaluation as a policy tool, particularly since the relative price of tradables was in any case high.

In the short run there was a complex interaction between balance of payments developments and the stabilization program. Improving the balance of payments was itself a goal of the program but it also served, directly and indirectly, to back up the program's other goals, increased its credibility, and made it easier to keep the exchange rate fixed. The main contributions were the reduction of the import surplus from the end of 1983 to mid-1985 and the shift of U.S. aid from loans to grants. The adoption of the stabilization program seems to have been instrumental in the timing of the U.S. emergency grant, which in turn improved the foreign payments position and reduced the risk that the program might be prematurely abandoned because of short-term pressure on the country's foreign currency resources.

[4] Under the prevailing conditions of currency control, private capital exports are affected by the timing of due dates of foreign obligations and new loan approvals as well as by the public's desire to alter its debt position. It should also be borne in mind that the estimate does not include capital exports generated by avoidance of repatriation of unrecorded foreign currency receipts.

[5] There should also be a gain from rolling over the foreign balances held outside the banking system by Israeli residents, holdings which entailed (social and private) loss of interest and resulted in overstatement of the net foreign debt. However, under the present severe currency control regime this gain may well fail to be realized in full.

[6] The experience of Israel (and other countries) teaches that inflation cannot be brought down steeply and abruptly without controlling the size of some major nominal variable such as the money supply, credit, or the exchange rate. The alternative to the policy adopted in mid-1985 was to impose more of the burden on monetary policy, which would have implied higher unemployment and acquiescence in slower disinflation. Monetary policy is less direct and takes longer than direct intervention through the exchange rate (especially considering the large share of tradables in Israel's resources).

The stabilization program affected the balance of payments in four main ways:

1. The tax burden was increased, real interest rates were raised, and the direct domestic demand of the public sector was cut; together, these reduced total domestic demand, and particularly demand for inventories. In the early stages of the program the contraction of domestic demand was reinforced by uncertainty about the prospects of unemployment.

2. The combination of high interest rates on credit and local-currency assets with the frozen exchange rate sharply reduced the attractiveness of foreign-currency assets; at the same time, the demand for foreign assets fell off some more as fears of a tax on financial assets declined and because of changes in the properties of resident deposits (the foreign-currency denominated Patam; the opening of new short-term resident deposits was prohibited, which reduced the propensity to get out of existing deposits).

3. In the short run, it became more profitable to produce tradables because the interest-rate gap between credit for domestic production and exports increased and because of the massive devaluation on the eve of the program. The latter raised the relative price of tradables above the equilibrium level consistent with the program's effect on domestic demand, and it should therefore have been largely neutralized by higher inflation. However, the actual price rise does not seem to have fully offset the excess rise in the relative price of tradables (the adjustment process kept price increases from slowing down in the early months of the program). The decision to peg the exchange rate to the U.S. dollar rather than to the currency basket also put some pressure on prices in the short run and encouraged the production of tradables, since the dollar fell against the other currencies.

4. Although the program increased the profitability of tradables, it had other elements which depressed output and to some extent caused the cutback of demand to reduce the GNP rather than the import surplus. Among the factors working in this direction were the supply-side effects of the rise in the real interest rates and the higher price of those imported intermediates which in the short run have only limited local substitutes. Real wages indeed fell sharply but this did not reduce real labor costs correspondingly (see Chapter IV). The sharp contraction of domestic demand itself entails a change in the destination of output. This is a long-term process to which the short-term rise in the profitability of tradables contributed little. The price freeze imposed as part of the program probably hampered the adjustment of production patterns and thereby intensified the deflationary effects on production.

Foreign demand for some of the country's products slackened while world trade grew only slightly, reinforcing the factors slowing structural change mentioned above. Thus the ratio of domestic resource use (seasonally adjusted and excluding direct defense imports) to GDP declined by 7 percentage points from the first to the second half of 1985, so that GDP declined by 4 percent and the ratio of import surplus (excluding direct defense imports and capital services) to GDP declined by 2.5 percentage points. The decline in import surplus was particularly marked in the third quarter; it was made up in the fourth

quarter and there was a further increase in the trade deficit in the first quarter of 1986.

The financing of the balance of payments became more favorable in the second half of 1985, with respect to both its extent and its trend. The decline in import surplus, on the other hand, carried on a trend that began in 1983. Some of the decline reflected destocking (which is akin to a capital flow, since it represents portfolio adjustment).

The change in balance-of-payments financing was reflected in the public's transactions with the Bank of Israel: in the first half of 1985 the private sector purchased $460 million in excess of its current-account deficit; in the second half of the year the excess purchases fell to $55 million and the black market premium on the dollar declined. A large part of current U.S. aid was (as in the last two years) received in the second half of the year; in addition, the first instalment of the emergency aid was also received in this period.

The foreign reserves rose by $500 million in 1985 — in each of the preceding two years they declined by a similar amount. In view of the high interest rates prevailing, the private sector would have been prepared to import more short and medium term capital (which would have increased the reserves further), but the Bank of Israel prevented this on the grounds that the additional capital flows could have jeopardized its monetary policy and based the growth of the reserves on speculative capital.[7]

The net foreign debt declined from $19.7 billion in 1984 to $19.2 billion in 1985. Net debt servicing nevertheless rose because both the average level of the debt and the interest rate rose (the latter may be due to a change in the interest-rate composition of the debt). Particularly marked was the further rise in the average real interest rate, which is now over 4 percent (it was negative until 1982). According to some indicators, the foreign debt burden increased; thus the ratio of foreign debt to GNP rose (as the GNP fell in foreign currency terms).[8]

In summary, 1985 saw a substantial improvement in the balance of payments, which not only compensated for the deterioration of 1981–83 but resulted in the best foreign payments position that Israel has experienced for a good many years. Nevertheless, part of the improvement is attributable to temporary factors such as the U.S. emergency grant, destocking, and the decline in purchases of capital goods. The last two were partly a cyclical adjustment and partly a response to higher interest rates. In the fourth quarter of 1985 and the first quarter of 1986 the import surplus did in fact increase. Furthermore, it is difficult to estimate the effect on it of a return to full employment. This would seem to depend on how domestic demand develops. Resumption of sustained

[7] However, speculative capital flows cannot easily be prevented for long. At any rate, in the second half of 1985, the capital-account improvement was to a large extent the result of speculative capital movements.

[8] If the comparison is made at 1985 prices (on the assumption that the relative price of GNP in foreign currency terms was closer to its long-run equilibrium in 1985 than in 1984), the ratio fell in 1985.

Table VII-2

THE BALANCE OF PAYMENTS, 1981-85[a]

($ million)

	1981	1982	1983	1984	1985 Jan.-Dec.	1985 Jan.-June	1985 July-Dec.
1. Net goods and services account	−4,261	−4,641	−4,971	−4,767	−3,972	−2,204	−1,768
Private sector	−1,703	−2,666	−3,247	−2,389	−1,019	−530	−489
Public sector[b]	−2,558	−1,975	−1,724	−2,378	−2,953	−1,674	−1,279
2. Net unilateral transfers	2,926	2,616	2,858	3,352	5,070	1,519	3,552
Private sector	1,131	1,053	937	755	752	313	438
Public sector	1,795	1,563	1,921	2,597	4,318	1,204	3,114
3. Net current account (1+2)	−1,335	−2,025	−2,113	−1,415	1,098	−685	1,784
Private sector	−572	−1,613	−2,310	−1,634	−267	−217	−51
Public sector	−763	−412	197	219	1,365	−470	1,835
4. Net medium and long term capital	1,239	1,221	2,317	1,164	−82	−61	−21
Private sector[c]	−33	4	1,015	94	−25	−37	12
Public sector	1,273	1,217	1,302	1,070	−56	−24	−32
5. Net basic balance of payments (3+4)	−96	−804	204	−251	1,016	−746	1,763
Private sector	−605	−1,609	−1,295	−1,540	−292	−254	−39
Public sector	510	805	1,499	1,289	1,309	−494	1,803
6. Net short-term capital movements	465	339	−433	238	−216	−328	112
Nonbanking private sector	52	294	51	−2	−135	−114	−21
Public sector[d]	413	45	−484	240	−81	−214	133
7. Capital movements of the banking system	762	1,624	235	−156	40	187	−147
8. Errors and omissions	−636	−306	−596	−391	−152	304	−456
9. Increase (−) or decrease (+) in foreign reserves held by central monetary institutions[e]	−495	−856	589	564	−689	584	−1,273

[a] See Tables VII-A7 and 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 n.e.s., and net interest paid to rest of world *less* surplus on port services (excl. fuel) and communications services.

[c] Includes net private investment from abroad.

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

[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.

economic growth would in any case entail more investment, thereby initially increasing both domestic resource use and the import surplus.

The considerable balance-of-payments improvement of 1985 in part represents a temporary overcorrection, although some of the forces behind it are of a more lasting character. Among the latter are the shift of U.S. aid from loans to grants, some of the reduction in the budget deficit, and the economic advantages of price stability. If the ratio of consumption (private and public) to GNP goes down permanently in future and the conditions for rapid growth are created, the foundation will be laid for sustained improvement of the balance of payments, and a gradual reduction in the foreign debt and the burden of servicing it.

2. THE CURRENT ACCOUNT

The current account improved for the second year running so that 1985 saw a surplus (of $1.1 billion) for the first time in many years, with the import surplus down by $0.8 billion and unilateral transfers up by $1.7 billion, mostly as the result of the shift of U.S. aid from loans to grants and the receipt of the U.S. emergency grant.

Direct defense imports (most of them financed by grants) and capital services, which account for a large part of the import surplus, again rose, by $400 million and $100 million respectively (see Table VII-3). By contrast, the civilian import surplus (excluding capital services) fell from $2,656 million in 1983 to $264 million in 1985. This is an impressive — if partly temporary — improvement. The country's balance of payments problems are to some extent a legacy of the past — a large foreign debt with an import surplus of $1.9 billion in capital services, and a confidence crisis reflected in speculative capital movements (see Section 3). This year unilateral transfers came to $5.1 billion, more than enough to finance the total import surplus of $4 billion. This means that the importance of the U.S. emergency grant of $750 million lay in the restoration of confidence at home and abroad (rather than in paying for the import surplus), which in turn contributed to the stabilization program and the ability to keep the exchange rate frozen without generating expectations of devaluation — even if the reserves are eventually drawn down (in consequence of a rise in the import surplus). This prevents speculative capital movements and may even make it possible to cut public expenditure more gradually.

Goods and services both contributed to the decline in import surplus.[9] Following an unexpectedly large increase in merchandise exports and a moderate decline in imports in 1984, the trade deficit again declined (by $0.5 billion). The services account (excluding capital services and transactions with Judea-Samaria and the Gaza District) showed a remarkable improvement in 1985, the export surplus rising by $600 million, compared with $50 million in 1984.

[9] However, a substantial part of the fall in services imports resulted from a decline in miscellaneous services, an item for which no breakdown is available and which may include errors and unrecorded capital movements (see below).

Table VII-3

GOODS AND SERVICES ACCOUNT, 1982-85[a]

($ million)

	$ million				Percent annual change					
					Price			Quantity		
	1982	1983	1984	1985	1983	1984	1985	1983	1984	1985
Imports										
Goods, excl. fuel and diamonds[b]	5,164	5,705	5,298	4,971	−3.9	−0.2	−1.9	15.0	−7.0	−4.3
Fuel	1,914	1,607	1,593	1,510	−8.3	0.6	−6.3	−8.4	−1.5	1.1
Diamonds	572	782	880	1,168	−0.7	−2.7	1.8	37.8	15.6	30.5
Services, excl. capital services[b]	2,563	2,736	2,780	2,228	−2.4	−3.3	0.9	9.4	5.0	−20.6
From Judea-Samaria and Gaza District	620	734	610	512	1.1	−5.4	1.5	17.0	−12.1	−17.3
Subtotal	**10,833**	**11,564**	**11,160**	**10,389**	−3.7	−1.4	−1.4	10.8	−2.2	−5.6
Capital services	2,746	2,682	2,964	2,773						
Direct defense imports	1,517	1,043	1,462	1,828						
Total	**15,096**	**15,289**	**15,586**	**14,991**						
Exports										
Goods, excl. diamonds[b]	4,002	3,822	4,531	4,735	−3.8	−0.9	−0.3	−0.7	19.6	4.8
Diamonds	905	1,001	1,035	1,263	−2.8	−6.0	−4.0	13.8	10.0	27.1
Services, excl. capital services[b]	3,109	3,226	3,316	3,397	2.6	−9.1	−0.7	1.1	13.1	3.2
To Judea-Samaria and Gaza District	780	860	756	730	5.6	−4.8	−8.3	4.4	−7.6	5.3
Subtotal	**8,796**	**8,908**	**9,638**	**10,125**	−0.6	−4.7	−1.5	1.9	13.5	6.7
Capital services	1,659	1,409	1,181	895						
Total	**10,456**	**10,318**	**10,819**	**11,020**						
Import surplus										
Civilian, excl. capital services	2,036	2,656	1,522	264						
Net capital services	1,087	1,273	1,782	1,879						
Civilian import surplus	3,123	3,929	3,305	2,143						
Total import surplus	4,641	4,972	4,767	3,972						
Trade deficit[b]	2,742	3,271	2,204	1,651						

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

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

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

The current-account deficit is the difference between domestic use of resources not financed by unilateral transfers and GNP; an improvement on current account may therefore be due to contraction of domestic demand as well as to an increase in GNP or unilateral transfers. Domestic demand has been declining since 1983; in 1984 it fell chiefly because private consumption and investment fell; in 1985, investment again declined, but private consumption levelled off. The volume of direct public sector demand declined by 2 percent (mainly in domestic defense outlays, which fell by 3 percent, and investment). However, direct defense imports (which are financed by U.S. aid and are to some extent a substitute for domestic procurement) rose by 25 percent (see Chapter V). The decline in domestic demand and the improvement in the current account were also reflected in the final destination of imports (see Table VII–A2): the share of inputs to exports increased from 23 percent of total imports in 1983 to 28 percent in 1985. Direct and indirect civilian imports for public consumption fell slightly in 1983 and have remained stable since. As against this, direct defense imports increased this year to nearly 12 percent of total imports, reversing the decline of the preceding two years (following a peak in 1981). Final imports and inputs to private consumption continued their downtrend, coming to 22 percent of total imports, while imports for investment declined from 13 to 12 percent of total imports.

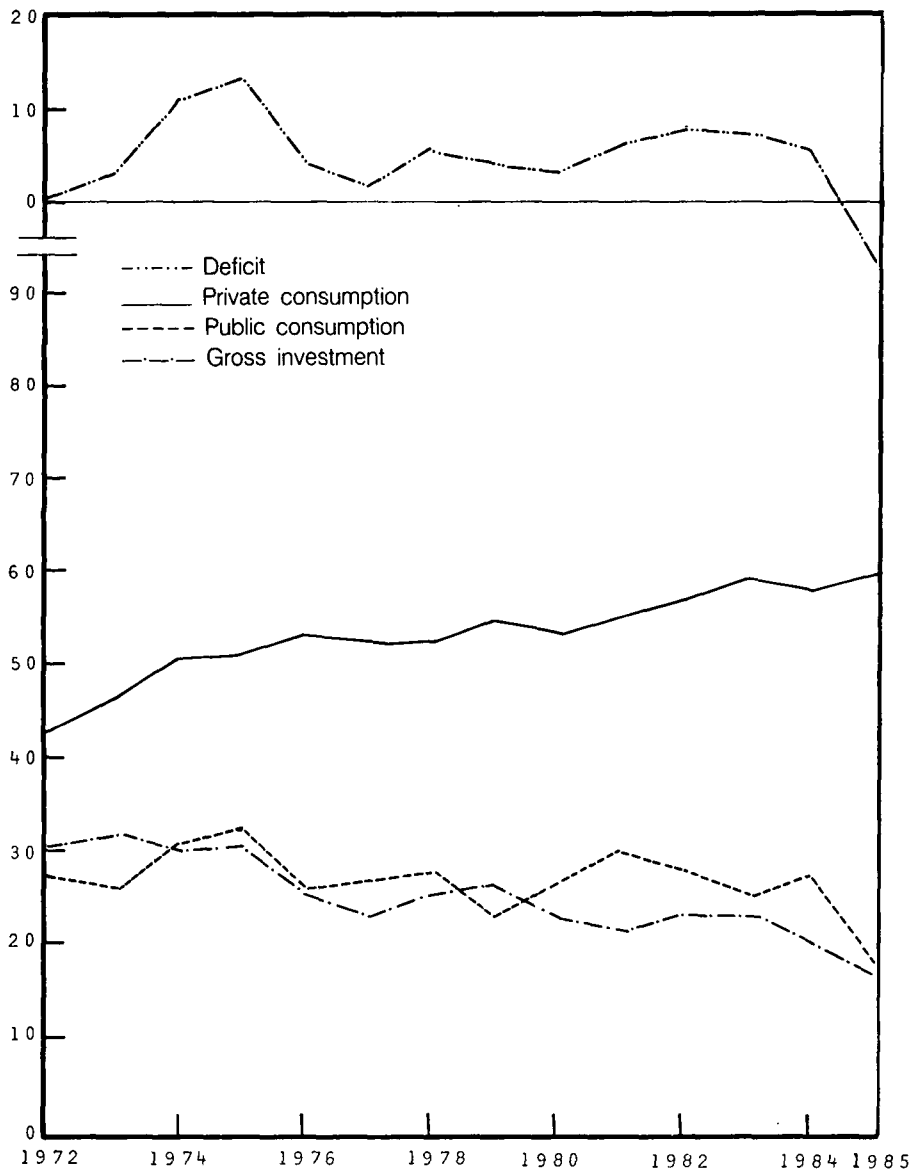
As stated, this year's impressive current-account improvement may turn out to be transitory, at least in part. As can be seen in Figure VII–3, the ratio of private consumption *less* unilateral transfers to the private sector to GNP has been rising steadily (reflecting the fact that GNP has grown more slowly than private consumption). A decline in this ratio implies a rise in the saving rate and the forces acting on the latter are difficult to evaluate. The corresponding ratio for public consumption, which was stable in recent years, dropped steeply in 1985. The development of gross investment has been unfavorable, bearing in mind its importance for growth, with the ratio to GNP falling from 30 percent of GNP in the early 1970s to 17 percent in 1985 (with ups and downs in the intervening years). If these trends in domestic resource-use continue, the current-account improvement will be sustainable only if GNP grows faster than private consumption. And if GNP growth is to be speeded up, the investment/GNP ratio must first be increased, and this implies current-account deterioration in the next few years. Differently put, long-run improvement of the current account requires a structural change which can come about if there is a temporary current-account deterioration. But it must be stressed that for investment and GNP to grow requires less, not more, government intervention. Cutting taxes on labor and capital, for example, might make it possible for GNP to grow even in the absence of any significant rise in investment and thus without any marked current-account deterioration.

The trends of 1984 continued into the first half of 1985. In July, however, a comprehensive economic program was adopted, which set itself the goal of simultaneously solving the two major economic problems of the last decade—inflation and the balance of payments.

All past attempts to improve the balance of payments were accompanied by

Figure VII-3

THE DEFICIT ON CURRENT ACCOUNT (AT OFFICIAL EXCHANGE RATE), CONSUMPTION, AND INVESTMENT AS PERCENT OF GNP, 1972-85[a]



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

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

higher inflation, because they were not part of a comprehensive program. When a current-account deficit was generated, the government took no direct measures to reduce public sector demand so as to reduce aggregate demand, but instead attempted to deal with the current-account deficit directly, by import taxation, export incentives, and devaluation. Measures of this kind are undoubtedly effective in the short run; they postpone imports (although they cause marked fluctuations in imports and exports). In the long run, however, nominal changes cannot become real changes unless the appropriate macroeconomic conditions are established. Devaluation may indeed initially lower the relative price of domestic products, so that imports are postponed; but if aggregate domestic demand does not contract, prices will rise in line with the devaluation, its real effect will be eroded, and the economy will return to the *status quo ante*. Moreover, an accommodating monetary policy in an indexation context contributed a good deal to blunting the effect of the devaluations, which were in practice reflected in higher inflation.

The taxation of imports and the promotion of exports do not of course affect the size of the import surplus as such, but act on imports and exports separately. The level of imports and exports is determined by many variables, including the economy's technological structure, the set of preferences, and the government's fiscal intervention. Taxing imports makes it more profitable to produce import substitutes, but under full employment, an increase in the output of import substitutes alters the industrial composition of output and leads to changes in factor prices, incomes, and the composition of demand; and the import surplus will eventually be reduced only if the ratio of domestic demand to GNP is reduced. Moreover, taxes and subsidies tend to impair the efficiency of resource allocation and hence productive capacity.

The first package deal was concluded towards the end of 1984. It cut private consumption (after a spurt of advance purchases) and domestic investment. Public consumption, however, rose, mainly because direct defense imports increased. The contraction of domestic resource-use was reflected in the decline of the civilian import surplus (excluding capital services), from $713.4 million in the third quarter of 1984 to $325 million in the fourth.

In 1985 developments were shaped by the package deals and the stabilization program that succeeded them. As stated, the 1984 trends carried into the first half of 1985 — the civilian import surplus (excluding capital services) continued to decline, mostly as the result of lower civilian imports. However, this decline had already begun in the last quarter of 1984, with the first package deal, and imports remained stable in the first half of 1985, with a slight deterioration in the second quarter as expectations of a new economic policy gathered force. The decline in the import surplus created favorable conditions for the stabilization program in July 1985. The impact of this comprehensive program, which attempts to overcome the balance of payments problem not through devaluation but by reducing domestic demand, was mainly felt in the third quarter: demand contracted sharply with rising unemployment and a fall in the GNP, which made it possible for the civilian import surplus to fall further. The improvement was particularly noticeable in imports of consumer

goods, whose volume declined by 15 percent in the third quarter, and in imported intermediates (excluding diamonds and fuel), whose volume was down by 10 percent. The decline in imports reflects cyclical changes resulting from the realization of pre-stabilization-program expectations (which had led to advancement of purchases), from high interest rates which throttled back inventories, and from expectations that the exchange rate would be held stable, at least in the near future (thus inducing postponement of purchases). In the last quarter imports rose again, in part as a corrective response to the previous decline, so that there was no sharp change in trend between the two halves of the year. Moreover, some developments ran counter to what had been expected, for example, the slowdown in the growth of industrial exports, or the rise in consumer and investment imports in the second half of the year, after a decline in the first half. It therefore seems that the cut in the government budget — attained through higher taxes rather than a cut in expenditure — was perceived as temporary, so that aggregate demand did not decline in the second half of the year. The trends of the last quarter of 1985 continued into the first quarter of 1986 — the volume of exports failed to grow and imports rose slightly. Nevertheless reduction of the civilian import surplus at the rate attained in the last two years cannot be sustained for long. Thus the fact that it has settled down at the present level does not imply a failure of the stabilization program.

The contraction of demand and the reduction of the import surplus were also reflected in real depreciation of the currency in 1985, with the relative price of imports and exports up (see Figures VII–1 and VII–2). The index of relative price of tradables (Tables VII–4, VII–A13 and Figure VII–4) indicates a rise in the profitability of producing import substitutes and exports, at least in the short run (in the long run, the price of tradables in Israel must conform to international equilibrium prices). Since the last quarter of 1984, the index of relative prices has tended to rise; with the adoption of the stabilization program and its initial devaluation, this index rose by some 7 percent against the five-currency basket, followed later by a slight erosion. Table VII–1 shows that the price of exports rose by 5 percent relative to the price of domestic resource use, while the relative price of imports rose by 7 percent.[10] With a calculation that takes into account the interest-rate gap between export and other credit (see note 10), the relative price of exports rose by 9 percent in 1985 (see Table VII–A13). Table VII–1 also shows that the terms of trade have improved, which contributed to the continued improvement in GNP growth and helped to reduce the import surplus.

Two further indicators of export profitability are real industrial wages relative to the price of tradables and the price of imported intermediates relative

[10] In Table VII–1 (based on CBS data) prices are calculated at the effective exchange rate, i.e., taking into account the flow of government disbursements to exporters, which declined considerably. However, where relative prices are concerned, it must be borne in mind that export credit is granted at the Eurodollar rate *plus* 2 percent, which is below the high interest rates on credit for domestic use.

Table VII-4

RELATIVE WHOLESALE PRICES, ISRAEL AND TRADING PARTNERS, 1981-1986/I

(index, 1984 = 100)

	IS exchange rate		Relative prices[a]	
	Against the dollar	Against foreign currency basket[b]	U.S. ÷ Israel	Basket countries ÷ Israel
1981	3.9	4.9	98.7	115.5
1982	8.3	9.6	96.8	107.2
1983	19.2	20.8	93.3	98.5
1984	*100.0*	*100.0*	*100.0*	*100.0*
1985	406.9	400.0	114.0	114.5
1983				
I	12.5	14.1	92.3	99.7
II	14.8	16.4	89.7	96.1
III	18.9	20.4	92.5	96.2
IV	30.4	32.3	98.8	101.9
1984				
I	44.5	47.0	99.3	102.3
II	65.6	68.5	98.8	101.5
III	106.1	106.1	92.4	98.0
IV	183.7	178.4	102.4	98.2
1985				
I	252.8	228.0	111.4	103.3
II	349.4	330.6	115.3	112.6
III	512.6	508.0	110.1	122.9
IV	511.5	530.6	110.1	119.2
1986				
I	512.6	554.6	105.2	120.1

[a] The IS exchange rate *multiplied by* the index of wholesale prices abroad *divided by* the Israeli index of wholesale prices of industrial output for the domestic market (excluding food and mining and quarrying).

[b] Average of the representative rates of five currencies (US dollar, German mark, pound sterling, guilder, French franc), weighted by the composition of Israel's foreign trade.

SOURCE: Israeli data, Bank of Israel and Central Bureau of Statistics; foreign price indexes, *IFS*.

to the price of industrial exports, at the effective exchange rate (see Table VII-A13). Both show a substantial decline, which began at the end of 1983. Wage increments granted in the last quarter of 1985 raised real wages but the price of imported intermediates, particularly oil, fell. But these indicators become meaningless when domestic demand changes: even if they show a rise in the profitability of exports, expansion of domestic demand may increase the import surplus.

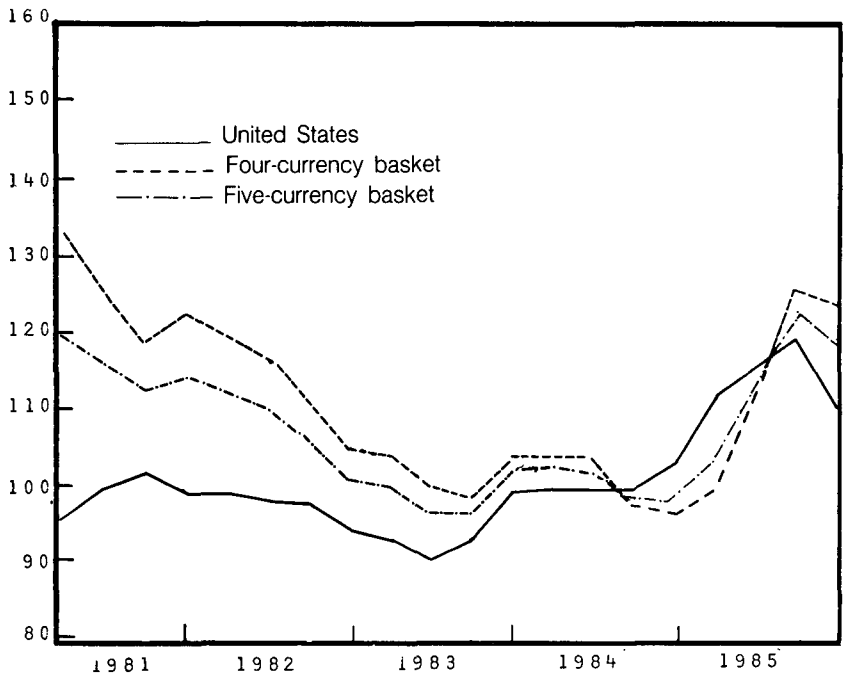
Merchandise Imports

As stated, the contraction of domestic demand, and particularly demand for investment and public consumption (excluding defense imports) improved the

Figure VII-4

RELATIVE PRICES OF INDUSTRIAL GOODS — WORLD/ISRAEL, 1981-85[a]

(1984 = 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. Seasonally adjusted.

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

current account — partly because imports declined. The volume of civilian merchandise (excl. diamonds and oil) fell by 4 percent (see Table VII-A1).

The sharpest fall in this year's imports, 14 percent, was in producer durables. The volume of consumer goods also fell, by 5 percent, a smaller decline than in 1984. Fuel imports were determined by the steep fall of world oil prices, which translated into a 6 percent decline in the domestic dollar price of imported fuel.

The country-of-origin composition of imports reveals the effect of the appreciation of the U.S. dollar from 1980 to mid-1985. This may indicate that Israel's imports, which in any case come mostly from Europe, have been slow to adjust. However, the data are derived from import statistics in current dollars; since there are no price indexes by trading region, and since relative prices between the United States and other countries have changed, the change in the volume of merchandise imports cannot be estimated.

Merchandise Exports

Increased exports also helped to reduce the import surplus. A substantial part of the increase was in merchandise (excluding diamonds), whose volume rose by 5 percent. This was less than the 20 percent increase in 1984, an exceptional year at home when, moreover, world trade expanded by 9 percent, compared with only $2\frac{1}{2}$ percent in 1985. Note also the steep rise in the relative price of exports and the sharp fall in real wages that occurred in 1985 (see Table VII–A13).

Israel's main export markets are in Europe, but their share has been declining gradually in favor of the United States (which received 29 percent of total merchandise exports in 1985). The shift was initially slow, because the production system was slow to adjust. The appreciation of European currencies in 1985 seems to have arrested the shift of exports to the American market, and has probably had a significant role in the growth of exports in the second half of the year.

The free trade agreement with the United States came into force in September, and it is still too early to evaluate its effects. Prior to the agreement, some Israeli exports benefited under the U.S. generalized system of preferences and some encountered a highly restrictive import regime. The new agreement provides for a transition period after which there will virtually be free trade in both types of commodity. The agreement with the United States should be viewed in the light of Israel's agreement with the EEC, which requires it to eliminate duties on EEC imports by the end of the present decade, so that there will be no grounds for discriminating against imports from the United States.

In the second half of the year the real interest rate rose in Israel, but exporters suffered less from this increased cost than production for the local market since they benefit from special credit terms. The stabilization program did provide for partial unification of exchange rates by replacing low-interest credit funds (in local and foreign currency) by foreign-currency funds charging the Eurorate *plus* 2 percent.

The Services Account

The services account deteriorated steadily and rapidly from 1979, when exports and imports of services balanced, until 1985, when the trend was reversed with a 40 percent decline in the services deficit (see Table VII–A5). Most of the deficit is attributable to capital services (mostly net interest on the public debt)—exports and imports of capital services both declined, by respectively $300 million and $200 million.

The surplus on current services (excluding transactions with Judea–Samaria and the Gaza District) rose substantially, from $0.5 billion in 1984 to $1.1 billion in 1985. This was the outcome of a 3 percent rise in exports (whose prices fell slightly) and a 20 percent rise in imports (whose prices rose by 1 percent). The item mainly responsible was imports of tourism, which dropped by 40 percent from the second half of 1984 to the second half of 1985, a decline that went beyond the direct effects of the stabilization program, since it

was a reaction to the heavy taxes previously imposed on foreign travel. At the same time, exports of tourism increased — the number of tourists rose, particularly tourists from Europe, reflecting the appreciation of the European currencies. (It should be mentioned that black market transactions, which last year seriously affected the recording of imports and exports of tourism, were much less of a problem this year.)

Exports of transport services levelled off, while imports fell by $100 million. World shipping continues to be slack; as a result, there was a steep decline in freights carried by Israeli shipping companies between foreign ports, whereas traffic to and from home ports expanded. The volume of airfreight carried by Israeli airlines increased, particularly between foreign ports, a trend that is now in its second year.

About half of the improvement on services account is attributable to the $300 million decline in imports of 'other services'. However, this figure should be regarded with caution: since no breakdown is available, the item may include errors and omissions or unrecorded capital movements. Be that as it may, imports under this heading have been declining gradually since mid-1984, stabilizing at a lower level in 1985.

3. FINANCING THE BALANCE OF PAYMENTS

Unilateral Transfers

The year under review is the first to reflect fully the decision taken at the end of 1984 that henceforth U.S. aid would be given in the form of grants instead of partly in the form of loans. As a result, the military grant-in-aid increased by $900 million.

In view of the difficulties encountered by Israel last year in financing its balance of payments, the United States provided an emergency grant of $1.5 billion, in order to permit implementation of the stabilization program without further balance of payments deterioration. Half of the amount was received this year and the second half is due in 1986. The shift from loans to grants is evidently of a more permanent character. The immediate result was to halt the increase in the foreign debt, which had been rising by 10 percent a year, with the increment going mainly to finance defense consumption. The replacement of new loans by grants, even for only one year, yields an annual saving of $100 million in interest payments. The change in the terms of the military aid therefore has a long-run stabilizing effect on the balance of payments. If the change becomes permanent and no new defense loans are taken, the public sector's interest payments will decline as the balance of old loans is repaid. The grants-in-aid thus reduce the import surplus in the long run and should improve Israel's credit rating in the international capital market, thereby giving it access to additional credit lines at a lower risk premium.

The public sector's debt to the United States has in recent years increased rapidly, and may have been the justification for the civilian grant. Comparison of the civilian grant with the debt servicing payments to the American govern-

ment between 1975 and 1985 shows that year after year, the major part of the total civilian grant-in-aid (not including the emergency grant of 1985) was returned as repayment of principal and interest on the debt. Except in 1983–85, no more than $50 to $200 million remained at Israel's disposal out of the total civilian grant after these payments.

In addition to the ordinary economic aid of $1.2 billion, Israel received the first half of the special emergency grant of $1.5 billion this year. As in previous years, disbursement of the economic aid was brought forward to the beginning of the U.S. fiscal year, i.e., to the last quarter of 1985. The timing of the payment of the emergency grant was determined by the date on which a comprehensive stabilization program was to be launched. It was evident that the Israeli government would find it easier to implement such a program after the Histadrut elections in May 1985. As expected, the receipt of the grants increased the seasonal fluctuations in the foreign currency reserves (see below).

The unilateral transfers of the private sector remained at approximately the same level as in 1984. In 1985 some 60 percent were received in the second half of the year. This is consistent with the substantial incentive given to private capital imports by the gap between domestic yields and those abroad (see below).

The basic balance of payments (see Table VII–2) improved by $1.3 billion in 1985, becoming a surplus of $1 billion, and also reflects this year's better financing situation. The corrected basic balance (which deducts advances paid to suppliers by the Ministry of Defence) shows a similar picture, going from a deficit of $0.7 billion in 1984 to a surplus of $0.4 billion in 1985.

Short-Term Capital Movements

There was a net outflow of short-term capital in 1985, with a net amount of $135 million generated by the private sector and $105 million in loan repayment (net) by the government (at the same time, the government reduced some of its claims on the rest of the world; on the implications for management of the foreign reserves, see Section 4 below).

The net private sector outflow (Table VII–A11) is at first glance surprising in view of the sharp rise in the cost of domestic credit (interest on overdraft facilities) compared with its cost abroad (interest plus the depreciation of the IS). Immediately after the stabilization program was launched the gap between the two reached a peak of 10 percent a month and then declined slowly to 6 percent at the end of the year, which is still very high (about 100 percent annually). This provided a strong incentive for holding IS-denominated rather than foreign-currency assets, and vice versa for liabilities. That there was nevertheless a net outflow of capital would appear to be due to the tight control over capital imports since 1984, whose efficiency is demonstrated by the large gap between the cost of credit in Israel and abroad.

This conclusion should, however, be qualified because the E&O item in the private sector's balance of payments represents mainly unidentified capital movements. When controls have been in force for an extended period, the public presumably learns how to circumvent them. Since the regulatory authority

Table VII-5

BALANCE OF PAYMENTS OF THE PRIVATE SECTOR, 1982-85[a]

($ million)

	1982	1983	1984	1985				
				Total	I	II	III	IV
Goods and services account	−2,666	−3,247	−2,389	−1,019	−196	−334	−238	−251
Unilateral transfers	1,053	937	755	752	164	149	208	230
subtotal: Current account	−1,613	−2,310	−1,634	−267	−32	−185	−30	−21
Long and medium term capital movements[b]	4	1,015	94	−25	−38	1	10	1
subtotal: Basic account[c]	−1,609	−1,295	−1,540	−292	−70	−184	−20	−20
Short-term capital movements[b]	294	51	−2	−135	−155	42	−99	77
Capital movements of banks on behalf of private sector	648	353	−440	−119	−81	205	166	−410
Errors and omissions[d]	−549	−689	−341	−236	10	−443	42	157
Effect of private sector on foreign reserves	**1,216**	**1,579**	**2,323**	**782**	**297**	**380**	**−90**	**195**

[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 (residual).

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

is also the reporting authority, the quality of the data will eventually deteriorate and it can be assumed that an increasing proportion of capital movements will turn up in the E&O item. In mid-1985 there was indeed a reversal in this item, indicating that the capital exports of the first half of the year had turned into capital imports in the second half. Nevertheless, there is no necessary connection between the absolute magnitudes of E&O and capital movements in either direction, since the E&O item will 'catch' only some of the underreporting. The errors are due mainly to changes in holdings of foreign currency outside the banking system: after many years of large foreign-currency purchases from the Bank of Israel, the trend reversed in mid-1985 (see Table VII–5). This was on the one hand due to transactions carried out to finance the import surplus, net loan repayment, or the extension of credit abroad, and on the other, to speculative transactions. The nonspeculative transactions have in recent years led to net demand for foreign currency, which grew rapidly during the 1980s, from $0.7 billion in 1982 to some $2 billion in 1984. However, actual purchases of foreign currency from the central bank exceeded this demand by between $0.3 billion and $0.7 billion a year.[11] As stated, the trend continued in the first half of 1985, especially in the second quarter, when the Histadrut elections were held and there were expectations of a comprehensive new economic policy. These developments stoked the public's fears that financial assets would be taxed and their liquidity restricted. As in the past, these fears launched a wave of speculative foreign-currency purchases, in excess of the current requirements for financing the balance of payments. As interest rates rose sharply in mid-year, the public began to sell foreign currency to the Bank of Israel. Quite apart from considerations of yield, this process may reflect greater confidence in the government. It must be remembered that although the hoarding of foreign currency outside the banking system protects these assets from taxes and from a change in the terms of saving schemes by the government, its price includes forgone interest and inconvenience. The black market premium on the U.S. dollar stabilized at a level only slightly above the official exchange rate in the second half of 1985 and early 1986; this too indicates that confidence in the government increased in this period.

4. THE FOREIGN DEBT AND THE RESERVES

Two major questions arise in connection with the foreign debt. The first is to what extent it diverges from the desired path. The second 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

[11] The data on foreign currency purchases by the private sector are from the Bank of Israel's accounts. The series started only in 1981. The difference between financing requirements and actual purchases is by definition equal to the errors and omissions item of the private sector balance of payment in Table VII–5.

first, as regards evaluation of its economic condition, the second, as regards its liquidity and ability to refund the debt, and the price of the debt.

Following a rapid rise in the net foreign debt[12] over many years (by an average of 16 percent a year since 1973), it was this year reduced by some $500 million from its end-of-1984 level. As stated, the decline is attributable to two main factors: the improvement in the terms of regular U.S. aid and the receipt of the first half of the emergency grant and the contraction of the import surplus since mid-1983. In addition, the upward bias of the estimates of the net debt seems to have increased.[13]

As regards divergence from the desired path, it is customary to relate the debt to the GNP. Disregarding temporary increases of the debt in response to unforeseen shocks, the economic justifications for a continuously growing foreign debt are taking advantage of profitable investment opportunities and raising consumption in anticipation of economic growth in the reasonably near future. An increase in the debt based on these two considerations will not as a rule increase the debt/GNP ratio, since there will be a corresponding rise in GNP.

As can be seen in Figure VII–5 (dashed curve), the data do not reveal the favorable development of the foreign debt in 1985; this is because the massive devaluation of July (which was an element of the stabilization program) depressed the GNP in dollar terms. This is corrected for in the index shown by the solid curve of the figure,[14] which reveals that the trend did change in 1985; it also corrects for the spurious improvement of the ratio in 1983, when devaluation was slowed down. The appreciation of European currencies also increased the ratio because it inflated the debt stated in dollars. Thus, for example, the direct gross debt increased by some $30 million (Table VII–6) although net debt retirement came to $413 million (Tables VII–A9 and VII–A11). This revaluation of the debt reflects some rigidity in the public's response to the depreciation of the dollar against the European currencies, which is at least partly attributable to the existence of foreign-currency control. Even when individuals correctly predicted exchange rate movements, they refrained from replacing their European currency liabilities by borrowing

[12] The net foreign debt is defined as total liabilities to the rest of the world (the gross foreign debt *less* foreign currency assets). In consequence of the rapid growth of Israeli banks' assets and liabilities abroad, while their net debt increased only slowly, another definition has come into use: the gross foreign debt of the nonfinancial private sector and the government, plus the net foreign debt of the banking system (see Table VII–6).

[13] Hoarding of foreign currency causes an upward bias in the estimates of the net foreign debt because these assets are not captured by the statistics. By definition, the net foreign debt should equal the sum of the current account deficits over all past years, 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, however, does not hold, for two reasons: first, the balance of payments estimates are net of valuation changes for foreign assets and liabilities due to variations of foreign exchange rates; and second, the official foreign debt statistics do not include unreported assets and liabilities.

[14] The corrected debt/GNP ratio was calculated from the real rate of increase of both magnitudes (instead of by translating GNP into dollars). The base year chosen was 1963, when the corrected and uncorrected ratios were equal.

Table VII-6

ASSETS AND LIABILITIES IN FOREIGN CURRENCY, END OF 1982–85[a]

($ million)

	1982	1983	1984	1985 I	1985 II	1985 III	1985 IV
1. Net liabilities[b] (3–4–5)	15,641	18,270	19,698	20,050	20,375	20,140	19,213
2. Gross liabilities[b]	28,109	29,670	30,299	29,426	29,701	29,435	30,084
3. Liabilities[b]	20,916	22,825	23,670	23,442	23,715	23,955	23,850
Government	13,378	14,789	15,580	15,536	15,474	15,528	15,595
Nonbanking private sector	2,723	3,159	3,410	3,309	3,368	3,340	3,426
Banking system (net)[c]	4,815	4,877	4,680	4,597	4,873	5,087	4,829
4. Foreign reserves	4,317	3,780	3,255	2,635	2,554	3,020	3,793
5. Exporters' credit to foreigners	958	774	716	757	785	794	844
6. Current liabilities	4,059	4,739	4,758	5,403	4,893	4,953	4,748
Banking system (short term)	2,094	2,444	2,388	2,265	2,604	2,732	2,431
Nonbanking private sector (short term)	1,010	1,021	960	897	959	913	1,025
Direct government debt (short term)	0	220	158	57	54	53	52
Debt repayable within one year[d]	955	1,054	1,252	1,284	1,276	1,255	1,240
7. Net current liabilities (6–4–5)	−1,216	184	787	1,111	1,553	1,139	111
Net current debt as percent of net debt	−7.8	0.7	4.0	5.5	7.6	5.7	0.6

[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.

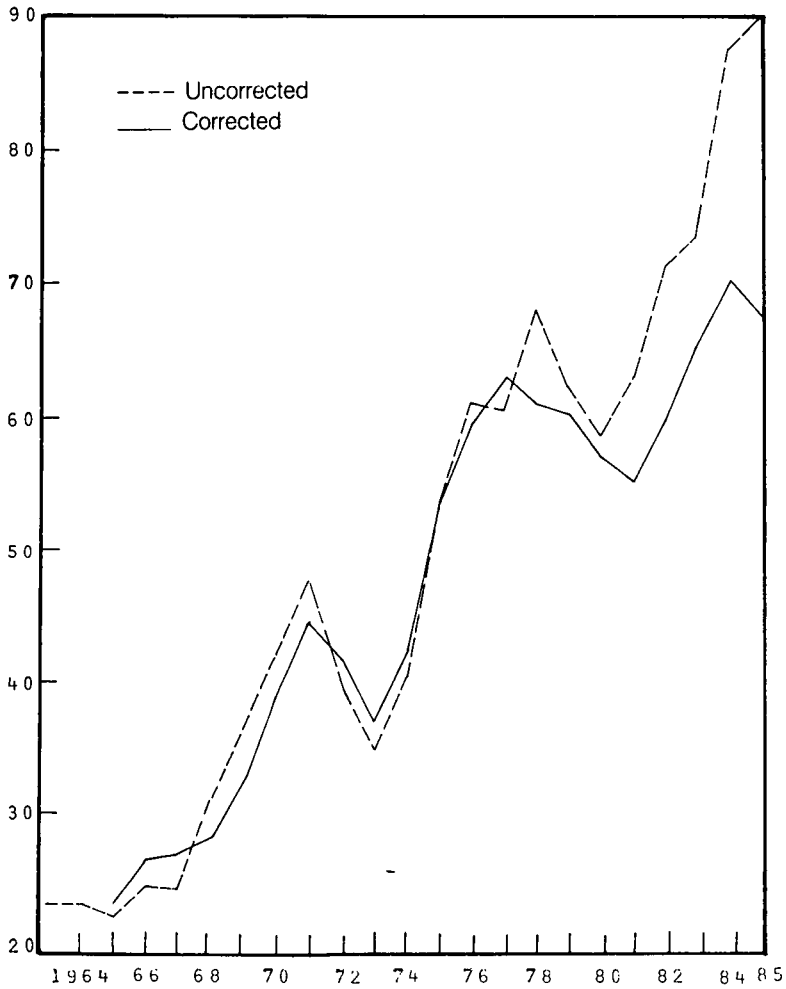
[c] Including liabilities on behalf of government.

[d] Long and medium term.

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

Figure VII-5

NET FOREIGN DEBT AS PERCENT OF GNP, 1964-85[a]



[a] For the uncorrected ratio, GNP is converted to dollars at official exchange rate. The corrected index is explained in note 14 in the text.

SOURCE: Central Bureau of Statistics and Bank of Israel.

dollars, probably because this would have required again applying for approval to the Controller of Foreign Currency — a time-consuming process which carried some risk that the application would be rejected.

The Debt Structure

The credit standing of a borrowing economy is affected by the composition of the debt as well as by its size. The composition of Israel's foreign debt is

Table VII-7

THE STRUCTURE OF THE NET FOREIGN DEBT, 1981-85

(percent of total net debt, end of period)

	1981	1982	1983	1984	1985 I	1985 II	1985 III	1985 IV
By borrower								
Public sector[a]	63	58	60	63	64	63	62	61
Private sector	37	42	40	37	36	37	38	39
Nonbanking private sector	11	11	13	14	13	13	13	13
Banking system	26	31	27	24	23	24	25	25
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
By lender								
Foreign public sector[b]	64	60	56	56	55	54	55	58
Foreign nonbanking private sector[c]	53	56	54	51	49	49	50	54
Banking system abroad[d]	−17	−17	−10	−7	−4	−3	5	−12
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
By term								
Long and medium	118	114	105	102	101	99	101	106
of which repayable within 1 year	*8*	*6*	*6*	*6*	*6*	*6*	*6*	*6*
Short	−18	−14	−5	−2	−1	1	−1	−6
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

[a] Government and Bank of Israel.

[b] Foreign governments and international institutions.

[c] Consists mainly 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.

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

different from that of most other debtor countries, and is such as to provide it, at a given size of debt, with easier access to the international capital market. Several factors combine to produce this result (see Table VII-7): (a) The chief borrower is the public sector, which is generally regarded as carrying a lower risk than private borrowers since the state has an exclusive source of revenue — the power to tax its citizens. The public sector's share in the total net debt declined somewhat from 1984, but it is still above the average of the last four years. (b) In recent years Israel has borrowed more from the nonbanking sector (governments and nonfinancial private sector abroad) than the total net debt. The balance is deposited with the international banking system and this (net) asset has increased to some 12 percent of total net foreign debt (some $2.3 billion) this year. Israel thus has a marked advantage over the developing countries, which borrow mainly from the international banking system. It should be kept in mind that when difficulties arise in servicing the debt and the lender is a government, both sides take political considerations into account; the commercial banks, by contrast, are primarily guided by commercial considerations. (c) The term structure of the debt is a good indicator

of the country's foreign liquidity position. The shorter the term of short-term assets and the longer the term of loans, the better is the liquidity position. A favorable term structure reduces the risk of the country's running into difficulties in refunding the foreign debt. The net current debt (see Table VII–6) is a more meaningful measure of the liquidity position than the foreign reserves alone and it would be as well if the public were not to confine their attention to the latter.

Net short-term assets (foreign reserves *plus* exporters' credit) for many years exceeded current liabilities. In recent years, this favorable structure has deteriorated steadily (except in 1983) until mid-1985, when, as mentioned, the trend reversed. Towards the end of the year foreign assets rose almost to the level of current liabilities (debts falling due within a year).

The Foreign Reserves

An open economy such as Israel's is particularly exposed to the uncertainties of world trade (oil crises, wars, and other unforeseen shocks). That is the reason why central banks hold foreign reserves. It is not easy to determine the optimum level of reserves for a debtor country such as Israel, but there are three important factors here: (a) the difference between the rate of interest on the foreign debt and on the reserves; at least on the margin, the former is higher than the latter, and the interest forgone is the cost of holding foreign reserves; (b) the difference in the maturity dates of receipts and expenditures; and (c) the magnitude of the gross foreign debt. A rapid and continued rise in these three jeopardizes the country's economic stability and therefore calls for higher reserves as a precautionary measure.

In 1983 and 1984 (according to calculations of the Bank of Israel's Research Department) the gap between the due dates of foreign currency receipts and expenditures increased, as did the gross foreign debt, while in 1985 the opposite occurred. The gap between due dates shrank appreciably, and the gross debt was reduced by some $200 million. Assuming that the difference in interest rates remained more or less unchanged (reliable data are difficult to obtain), and assuming also that the level of the reserves at the beginning of 1983 was satisfactory (covering $3\frac{1}{2}$ months of imports), then the reserves should have been increased in 1983 and 1984, and drawn down or kept stable in 1985. In fact, a steep decline was recorded in 1983–84 and a steep rise in the second half of 1985. It is nonetheless evident that because unexpected shocks may occur, the reserves cannot always be maintained at the optimum level in the short run; in the long run they should not be allowed to drop significantly below the optimum.

In the first half of 1985 the foreign reserves shrank to some $2.6 billion. By mid-year they sufficed to cover no more than 2 months of imports, but the ratio improved towards the end of the year. The level of the reserves has become one of the main indicators by which the international banks establish the credit ceiling for borrowers and the risk premium on loans. Hence the importance of the reserves, even though they do not reflect all aspects of a country's foreign liquidity position.

Table VII-8

INDICATORS OF THE FOREIGN DEBT BURDEN, 1981-85[a]

	1981	1982	1983	1984	1985			
					I	II	III	IV
$ million								
Interest on gross debt	2,212	2,612	2,516	2,821	2,852	2,846	2,758	2,651
less Interest receipts	1,450	1,619	1,386	1,163	1,076	1,038	947	882
Interest on net debt	762	994	1,130	1,659	1,776	1,808	1,812	1,768
Other capital services								
Debit	115	138	166	143	137	139	128	123
less Credit	34	40	22	18	18	17	14	11
Repayment of principal	1,163	1,075	955	1,054	1,080	1,100	1,136	1,252
Total net debt servicing	**2,005**	**2,167**	**2,229**	**2,837**	**2,975**	**3,030**	**3,062**	**3,132**
Percent								
Interest/net debt[b]	6.0	7.0	6.8	8.7	8.7	9.2	9.0	8.7
Real interest[c]/net debt[b]	−3.9	−0.8	1.5	3.7	3.8	4.4	4.5	4.3
Interest/net available resources[d]	3.1	4.0	4.1	6.4	6.8	6.9	6.8	6.8
Net interest/exports[e]	9	12	13	18	19	19	19	18
Ratio of net debt servicing to								
Exports[e]	23	26	26	30	32	32	32	32
Exports[e] + unilateral transfers	17	20	20	22	23	22	21	21
GNP	9	10	9	13	13	14	14	14

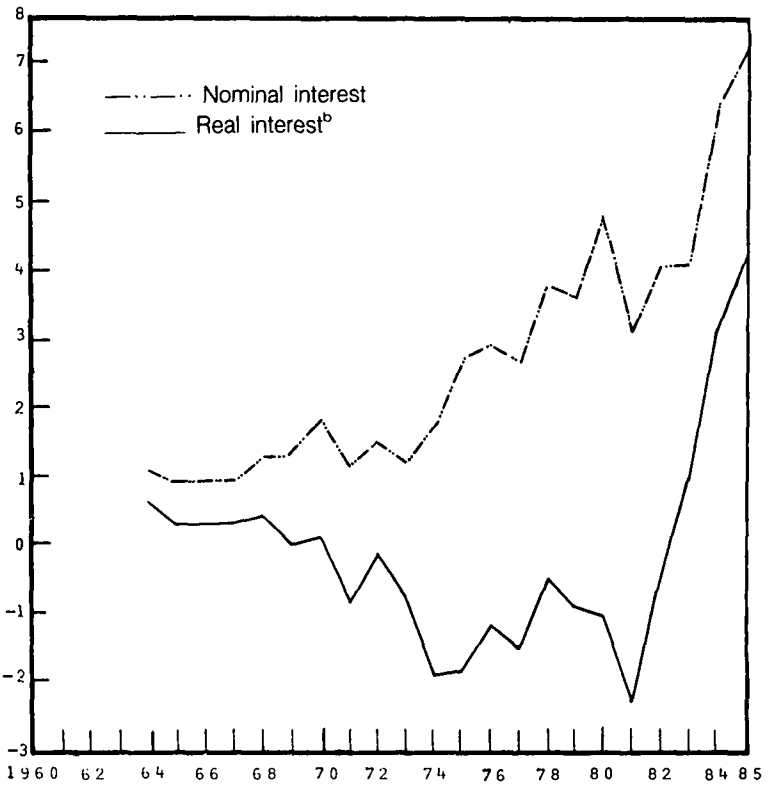
[a] Figures may not add owing to rounding.
[b] Calculated with debt lagged six months.
[c] Deflated by five-year moving average of CPI for industrial countries (*IFS*).
[d] GNP *plus* unilateral transfers.
[e] Exports f.o.b., excluding capital services.

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

Figure VII-6

NET INTEREST ON THE FOREIGN DEBT, 1964-85

(percent of net available resources[a])



[a] See note d to Table VII-8.

[b] See note c to Table VII-8.

SOURCE: Table VII-8 and underlying worksheets.

The Foreign Debt

The financing of economic activity by foreign borrowing requires part of current income to be devoted to servicing the debt. In 1985, debt servicing came to 7.2 percent of net available resources (GNP *plus* unilateral transfers). There are many indexes of the burden of foreign debt, and a selection is presented in Table VII-8. As can be seen, they all deteriorated except for the ratio of net debt servicing to export proceeds *plus* unilateral transfers.

Interest payments by the public sector and repayment of short and medium term loans by the private sector were responsible for this year's debt-servicing increment. The net increase in public sector interest payments reflects both an increase in outlays and a decline in interest received on the reserves (respecti-

vely $60 million and $120 million). The decline in receipts was connected with the low level of the reserves in the fourth quarter of 1984 and at mid-year in 1985 and with the decline in world interest rates. The latter, however, had only a small effect on the payments, since short-term debt and long-term loans with variable interest amount to only 11 percent of the government's gross debt and the lower interest rates were outweighed by the 8.3 percent rise in the debt from 1983 to 1984.

One might ask why the marked improvement which set in in mid-1985 — in the capital account, the debt position, and the reserves — has not had any effect on the debt burden. The debt burden, however, is inherently downward rigid; the debt is largely a stock of long-term obligations, and current interest payments will decline only after sustained reduction of the debt. If repayment of principal is taken into account, the indicators of Table VII–8 show deterioration — on the one hand, the interest payments are not yet affected by the reduction of the debt; on the other, repayment of principal has increased. Furthermore, the effect of the large (real) depreciation of the currency is to reduce the GNP in dollar terms, so that the denominator of the indexes is reduced; combined with the increased numerator, the result is an unfavorable picture, in spite of the fact that both are steps in the right direction.