CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

ECONOMIC DEVELOPMENTS in 1967 showed a change in trend. The second half of the year was marked by recovery and rapid economic growth, following the recession and stagnation that began in 1966. The expansionary countercyclical policy implemented by the Government and the Bank of Israel as from the end of 1966, and especially the increase in Government spending and deficit financing during and after the war period, considerably expanded the liquidity of the economy and augmented domestic demand. This checked the contraction of economic activity and employment, leading to a decline in unemployment and subsequently to rapid economic growth. Various indicators show that the uptrend carried over through the early months of 1968.

Because of the contrasting movements in the two subperiods, the annual averages for 1967 as a whole give no indication of the turning point reached during the year.

The first half of 1967 saw a continuation of the standstill in national product which set in at the end of 1965. The Government began to implement its reflationary-policy measures in the latter part of 1966, but their effects were not felt during the first half of 1967, since the forces slowing down the growth of aggregate demand during the recession continued to operate at considerable strength. Nevertheless, the trend may have started to turn in several spheres in early 1967. However, this was temporarily checked during the period of prewar tension and hostilities. Around the middle of 1967 economic activity began to pick up, and GNP started to advance at the rapid annual rate of some 10 percent. The recovery spread to most sectors of the economy, but in particular the public sector and industry. Even in construction, which was most severely affected by the slowdown, the downtrend was arrested in the second half of the year.

The growth of aggregate demand was connected with the expansion of private and public consumption, as well as with the halting of the decline in investments. Most of the increase in public consumption occurred in the second and third quarters of 1967, whereas private consumption rose primarily in the second half of the year. Investment reached its nadir in the second quarter of 1967, being hard hit by the call-up and the war. In the second half of the year the falling trend was checked, and investment returned to its end-1966 level. Exports continued to expand during the recession, and the demand generated thereby increased in 1967 to the same extent as in the preceding year.

MAIN ECONOMIC INDICATORS, 1964–67

(percentages)

	Increase or decrease (–) as against previous year 1964	1965	1966	1967	First half of 1967 as against first half of 1966[a]	Second half of 1967 as against second half of 1966[a]
Resources and uses (at constant prices)						
Aggregate domestic demand	12.0	5.8	–0.9	2.0	–4.8	9.3
Gross national product	10.2	8.2	1.0	2.2	–3.7	10.9
Gross national product per capita	5.9	4.6	–1.6	–1.0	–5.7	8.9
Private consumption	11.0	8.2	3.1	1.7	–2.8	8.1
Private consumption per capita	6.6	4.6	0.5	–1.5	–4.8	6.2
Public consumption	2.3	8.6	7.3	28.9	29.2	31.6
Gross investment	23.0	–1.9	–17.6	–25.7	–40.3	–9.7
Foreign trade—goods and services ($)						
Imports	16	3	4	6	–3	12
Exports	8	14	16	10	2	21
Import surplus	28	–9	–15	–2	–12	0
Population and employment						
Average population[b]	4.1	3.4	2.6	3.2	2.1	4.4
Number of employed[c]	5.6	3.0	–0.6	–4.9	–7.6	–2.2
Number of unemployed (daily average)[b]	–14.7	–4.7	126.8	57.7	192.7	1.2
Prices and national income (nominal)						
Average monthly wages per employee	12	18	19	0.5	—	—
Wages per normal hour of work	13	19	20	4	7	2
GNP prices	6	9	8	1	—	—
Consumer price index (annual average)	5	8	8	2	3	0
National income	17	20	9	4	—	—
National income per capita	12	16	6	0	—	—
Finance						
Money supply (annual average)	13	9	7	20	15	26
Bank credit to the public (annual average)	20	10	19	36	35	37

[a] The data for the first and second halves of the year are in some cases based on slightly different definitions from those applicable to the data for the year as a whole.
[b] Including East Jerusalem.
[c] Excluding East Jerusalem.

The Government and the Bank of Israel instituted their reflationary measures in the second half of 1966, when the economic slowdown grew more pronounced and unemployment assumed large dimensions. The steps taken by the Government in the last quarter of 1966 and the first quarter of 1967 were still on a limited scale: subsidies and measures to encourage employment were expanded somewhat, the tax authorities were more lenient in collections, with the result that they dropped by more than was warranted by the recession, and private investors were given increased assistance under the amended Law for the Encouragement of Capital Investments. The expansionary monetary policy pursued by the Bank of Israel in the second half of 1966 was reflected by a substantial reduction of liquidity ratios, the stepping-up of rediscounting operations, and the lowering of interest rates on the Government Short-Term Loan. Bank of Israel credit to the Government was also expanded considerably as from the beginning of 1967.

During the second quarter of 1967, when the budget for 1967/68 began to be implemented and owing to the special requirements of the prewar and immediate postwar period, the demand surplus rose appreciably, and there was a large injection of credit into the economy by the Government. Tax revenue fell off precipitately, while expenditure rose sharply, especially that for security purposes. The increased public sector spending, which for the most part took place in the domestic market, was financed in April and May by large-scale credit from the Bank of Israel and in June by increased capital imports. The total amount of financing provided the public sector by the banking system and from abroad during 1967 reached IL 1,735 million, as contrasted with IL 740–750 million per annum in 1965 and 1966.

These measures did not bring about a change in the trend of economic activity during the first half of 1967, both because their effects began to be felt only after some time-lag and owing to the sharp contraction of investments during the second quarter of the year, which offset the expansionary influence of the measures described. The increase of public sector demand and the infusion of additional purchasing power, which continued in the third quarter of 1967 as well, led to a rise in employment, private incomes, and private consumption. While investments also expanded, reverting to their prewar level, the growth rate failed to match that for the national product and consumption, since the expansion of economic activity and of Government incentives in the form of grants and additional financing is felt in the investment sphere only after some time-lag.

On an annual average, the growth of real GNP came to about 2 percent, compared with approximately 1 percent in 1966. GNP per capita thus remained virtually unchanged,[1] after edging down by about 1.5 percent in 1966.

Real private consumption was up about 2 percent, and the average per

[1] If the contractionary influence of East Jerusalem is excluded for purposes of the comparison.

capita level was similar to that in 1966, if we exclude for purposes of the comparison the lower consumption of East Jerusalem. The increase in public consumption was much faster, totalling some 29 percent at constant prices, as contrasted with 7–9 percent during the two preceding years. Investments fell off by approximately 26 percent, after having declined by some 18 percent in 1966.

The resumption of economic growth in the second half of 1967 was reflected by greater demand pressure in the labor market. The number of gainfully employed advanced by about 2.5 percent as compared with the first half of the year, following a steady decline from the beginning of 1966. Employment went up in all economic sectors. It rose faster than the labor force, so that the number of jobless declined sharply. According to manpower surveys, the proportion of unemployed within the civilian labor force was approximately 18 percent lower in the second half of 1967 than in the first half. The drop in unemployment during this period is also borne out by National Employment Service data. These show that unemployment continued downward in the early months of 1968 as well.

Average monthly wages per employee rose by only 0.5 percent in 1967, as compared with increases of 18 to 19 percent in 1965 and 1966. The stability, and even slight decline, of wages was maintained from the beginning of the second quarter of 1966 until the middle of 1967. This development can be attributed to the completion of the payment of retroactive wage adjustments, the decrease in bonuses paid over and above the official wage tariffs, the nonpayment of a cost-of-living allowance increment, and the absence of pressure for rises in tariffs. Because of the existence of large-scale unemployment, even the wage agreements signed prior to this period were not implemented in full. During the second half of 1967, however, average earnings went up slightly, owing mainly to wage drift and partly to the moderate tariff rises granted in some branches.

The country's trade deficit continued downward in 1967, in line with the trend of the two preceding years. It was slashed by $ 126 million, or 39 percent—from $ 321 million in 1966 to $ 195 million. This followed smaller decreases in 1965 and 1966, which came in the wake of the record deficit of $ 454 million in 1964. The sharp decrease in the trade deficit in 1967 was achieved both by reducing imports and by expanding commodity exports.

As to imports, the recession was reflected by a pronounced drop in all component groups: investment goods, raw materials, and consumer goods. Total commodity imports fell by $ 68 million, or approximately 9 percent—from $ 795 million in 1966 to $ 727 million. In part, this decline may also reflect the drawing-down of existing stocks of imported goods. The downtrend in imports was reversed in the third quarter of 1967, and the figure continued to rise in the early months of 1968.

Commodity exports expanded in 1967 by $ 58 million (including sales of ships and aircraft in the amount of $ 13.7 million). Total exports during the year reached $ 532 million, 12 percent more than in 1966. This followed an increase of 18 percent in 1966, but calculated at constant prices, the growth rate was the same in both years. Agricultural exports accelerated somewhat as compared with 1966, posting a 15 percent gain as against the previous year's 9 percent. On the other hand, the growth of industrial exports slowed down appreciably—3 percent only in contrast to 19 percent in 1966. The deceleration can be largely attributed to two branches which market nearly all of their output abroad—diamonds and minerals. Both showed smaller figures in 1967, following a protracted upward movement. The setback was in each case due chiefly to sagging demand abroad. On the other hand, slightly faster growth rates were recorded by a long list of other commodities produced primarily for the domestic market. The latter development reflects the influence of the economic slowdown and the increased export incentives, which more than offset the effects of unfavorable demand conditions abroad and the dislocations caused by the war.

The devaluation of the Israeli pound in November 1967 by 17 percent (from IL 3.00 to IL 3.50 per dollar), in the wake of the devaluation of the pound sterling, did not make itself felt on the country's foreign trade in the year reviewed.

In contrast to the considerable improvement in the trade balance, imports of services were much higher in 1967, owing to the greater security requirements. As a consequence, the import surplus of goods and services declined by only $ 8 million to stand at $ 437 million.

Capital imports reached a new high of $ 780 million, as compared with the $ 437 million deficit on current account. The increased capital inflow permitted a substantial $ 217 million accumulation of foreign currency reserves and the repayment of $ 12 million in foreign short-term liabilities.[1] The record capital inflow was the outcome of World Jewry's assistance to Israel during the year reviewed, and was concentrated in two items: the Emergency Appeal and proceeds from the sale of Development Bonds. Proceeds from the various appeals were up $ 226 million compared with 1966, while net receipts from Development Bond sales soared from $ 11 million in 1966 to $ 175 million. On the other hand, there was a striking decline in investments from abroad, while the remaining items showed insignificant changes. It is noteworthy that in previous years unilateral transfers ran $ 100–200 million below the deficit on current account, while in 1967 they exceeded the deficit by $ 85 million.

The large-scale accumulation of foreign exchange reserves, the deficit financing of the war, and the measures instituted by the Government and the Bank of Israel to stimulate demand in the economy were mirrored by a substantial increase in the liquidity of the economy. The average level of the money supply

[1] There is a residual of some $ 114 million representing "errors and omissions", which renders the analysis of the balance of payments more difficult.

was 20.3 percent above that in 1966, following a rise of 7.3 percent the year before. Besides the rapid growth of the money supply, there was a still more rapid expansion of less liquid deposits with the banking system. Lumping these two items together yields an average annual increase of some 30 percent, as compared with 12.4 percent in 1966. But if we also add bill brokerage credit (the outstanding balance of which contracted) and holdings of the Government Short-Term Loan, the growth of financial assets in 1967 drops to 23.9 percent, compared with 14.3 percent in 1966.

The main sources expanding financial assets were the larger volume of Bank of Israel credit to the Government (especially in the first half of 1967), the increase in bank credit to the public (mainly in the second half of the year), and the marked rise in net foreign currency assets with the banking system, which occurred chiefly in the immediate postwar period. Net foreign currency assets expanded during the year by $ 110 million, after having decreased by $ 23 million in 1966, while bank credit to the public was up IL 518 million, or 34 percent, compared with a rise of IL 291 million (23.7 percent) in 1966. Not all of the incremental bank credit in 1967 represented a net infusion of credit into the economy, part of it reflecting a switch from bill brokerage, which fell off sharply during the year. Short-term credit to the public, which includes both ordinary bank credit and credit provided through the bill brokerage market, was IL 241 million (9.4 percent) larger in 1967, as contrasted with a rise of IL 539 million, or 27 percent, the year before. The shift to relatively cheaper credit in 1967 and the decline in the interest rate in the bill brokerage market dampened the average rate of interest on short-term credit granted through the banking system.

Not all of the monetary expansion found expression in a growth of aggregate demand, since the public's liquidity preference absorbed part of the incremental liquid assets. The expansion of aggregate demand in the second half of the year, which occurred at a time of unemployment and stable production costs, did not push up the price level, which held steady from the middle of 1966 until the end of 1967.

The rise of about 4 percent in disposable private income per capita was not accompanied by a parallel rise in per capita consumption, which remained at the same level as in 1966. The consumption level thus did not immediately adjust to the income level, and this caused private saving to soar by more than IL 400 million. Gross private saving returned to the level of the boom years 1964 and 1965, reaching approximately 20 percent of private income from domestic sources. Public sector saving, on the other hand, was down by more than IL 1,000 million, so that the national saving figure declined sharply.

The increase of private saving was reflected by a stronger demand for financial assets, whereas demand for housing weakened. The much larger supply of liquid assets, together with the stability of prices and the more sluggish growth of demand for credit in various sectors, depressed the rate of interest paid in the bill brokerage market, on the Short-Term Loan, and on time deposits. Part of the additional liquid funds were absorbed by the medium- and long-term bond market, through the stepped-up sale of Government and other bonds, without this being accompanied by a fall in the interest rate.

The turning point in economic activity, which became discernible in the second half of 1967 and the beginning of 1968, was largely the outcome of the reflationary policy pursued, and while desirable in itself, there is a danger that the growth may get out of hand if the necessary steps are not taken in time. Among the outstanding achievements of the period of economic restraint were the virtually complete stability of prices from May 1966 until the end of 1967, the arresting of the upward movement of wages and other production costs, a sharp drop in free-market interest rates, and a notable improvement in the foreign trade balance.

To be sure, a price had to be paid for these achievements in the form of a deceleration of the economic growth rate to 1–2 percent per annum during the last two years. On top of this, investment declined and unemployment rose after a long period of full employment. If the policy of economic moderation had not been pursued, the import surplus would have continued to widen and foreign exchange reserves would have dwindled. The country's ability to meet the test of war—the period of tension and preparedness that preceded the outbreak of hostilities and the needs that arose in the postwar period—without shaking the economy can be directly attributed to the margin for expansion which the recession created.

These gains now stand in danger of being erased by the transition to accelerated economic growth. The first warning signs are already apparent, especially in the spheres of foreign trade and prices. There are also some indications of a shortage of various categories of skilled labor. The threat of inflationary pressures can be averted and a balanced economic growth within reasonable limits can be achieved, provided that measures to arrest or prevent undesirable developments are instituted in time. Several measures toward this end have in fact been adopted already, the most important of which are the slashing of IL 200 million from the development budget and the raising of the liquidity ratios on bank deposits. These steps are also likely to dampen expectations of a price rise, thereby restraining inflationary pressures.