CHAPTER VII

THE BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

A current account deficit of nearly $1 billion was recorded in 1987 in the external current account, primarily due to a marked increase in direct defense imports, part of which was already paid for in earlier years. After deducting these pre-paid imports, the current account deficit approximated $250 million, compared with surpluses of $820 million and $1.1 billion in 1986 and 1985, respectively, and an average deficit of $1.9 billion in 1982–84 (adjusted[1], see box). The rest of the current account deficit in 1987, after adjustment for advances paid on defense imports, was the result of a rise in the civilian import surplus, a $950 million decline in unilateral transfers to the public sector (mainly due to the end of the two-year supplemental U.S. aid) and, as against these, an increase in private sector unilateral transfers (see Table VII–1).

The net foreign debt remained constant, for the third year running, at $19.2 billion,[2] although it declined to 57 percent of GDP (see Fig. VII–4). Foreign currency reserves continued to rise, reaching nearly $6 billion in 1987, due to sizeable private capital imports together with a surplus in the government's foreign currency accounts. As in the preceding year, these larger reserves remained equivalent to 3.7 months of imports, as imports rose in both volume and value terms.

The 1987 civilian import surplus came to 10 percent of GDP, compared with 9.5 percent in 1986 and an average of 13.5 percent in 1982–84. Even after excluding capital services, in which net interest payments on foreign debt declined, the civilian import surplus increased by approximately $730 million. About a third of this increase was due to a real growth of imports and exports, another half reflected the deterioration in the country's terms of trade, and the rest—the rise in the dollar prices of both imports and exports as the dollar weakened against the other major currencies.

[1] Adjusted for advances paid on future supplies of defense goods; see box.

[2] The change in the net external debt is not equal to the current account deficit or surplus, for two reasons: a) the dollar value of the foreign debt is revaluated as cross rates change abroad; b) there is a substantive difference of definitions between the current account and the foreign debt, since net investment from abroad and assets held by the privatesector, excluding the banking system, are not included in the net foreign debt.

Table VII–1
BALANCE-OF-PAYMENTS INDICATORS, 1981–87

	1981	1982	1983	1984	1985	1986	1987
$ million							
Exports, excl. capital services	9,250	8,787	8,894	9,631	10,184	11,244	13,359
Civilian imports, excl. capital services	10,498	10,887	11,592	11,162	10,537	12,233	15,074
Import surplus							
Total	4,260	4,566	4,821	4,767	3,915	3,904	5,824
Civilian	2,054	3,049	3,779	3,305	2,087	2,701	3,353
Civilian, excl. capital services	1,249	2,099	2,698	1,531	354	989	1,715
Imports of capital services, net	805	950	1,081	1,774	1,733	1,712	1,638
Direct defense imports	2,205	1,517	1,043	1,462	1,828	1,202	2,471
Unilateral transfers, public sector	1,725	1,495	1,872	2,543	4,266	4,215	3,280
Unilateral transfers, private sector	1,200	1,110	993	823	809	1,159	1,547
Current account deficit (–) or surplus (+)	–1,335	–1,961	–1,956	–1,402	1,160	1,470	–998
Net medium- and long-term capital movements	1,268	1,147	2,340	1,287	80	501	353
Basic deficit (–) or surplus (+)[a]	–67	–814	384	–115	1,240	1,971	–645
Implied private capital imports[b]	114	943	514	–523	–892	110	840
Net foreign debt	13,373	15,641	18,270	19,686	19,253	19,156	19,224
Net current foreign debt[c]	–1,393	–1,221	211	754	142	–760	–1,251
Foreign reserves, end-of-year[d]	3,814	4,317	3,780	3,255	3,793	4,868	5,962
Index, 1980 = 100							
World trade (volume)	101	98	100	109	113	118	122
Terms of trade, exports and civilian imports, excl. capital services	102	107	111	107	107	110	107
Terms of trade, merchandise excl. diamonds	99	102	103	102	105	111	109
Relative prices[e]							
Imports	96	91	85	87	93	83	80
Exports	98	93	91	92	92	82	77

[a] Basic account = current account, plus medium- and long-term capital movements.

[b] Source: Table VII–17.

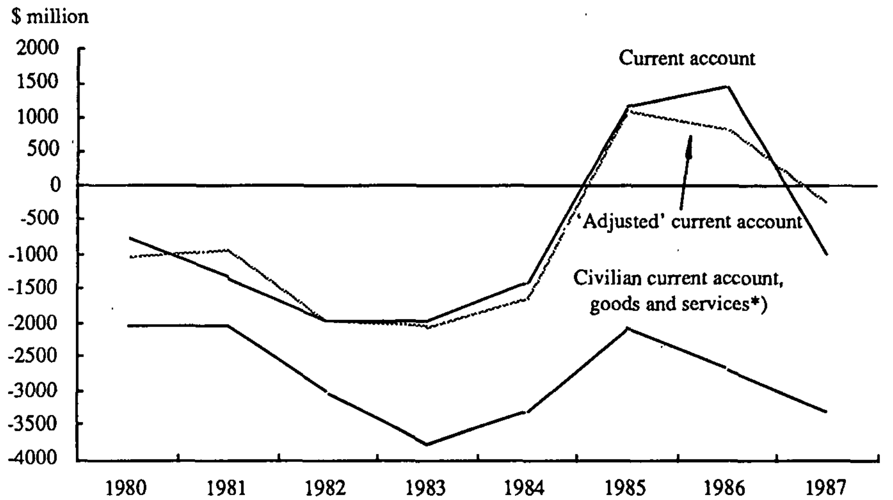
[c] Net short-term debt plus medium- and long-term debt due to be repaid within one year.

[d] Held by central monetary authorities.

[e] Relative to domestic use of resources. Calculated from national accounts indexes of import and export prices and price index of domestic use of resources. Excludes direct defense imports.

The moderate real rise in the civilian import surplus coincided with a substantial expansion of foreign trade: Total civilian imports (excluding capital services, see Table VII–3) increased by 11.6 percent in real terms. This increase was shared by all items, except fuel. Total exports (excluding capital services) rose by 10.5 percent. This rise was not evenly distributed across items: industrial exports expanded at about the average rate of growth, exports of tourist services were impressively higher, and agricultural exports declined after their substantial growth the previous year.

Figure VII–1
THE CIVILIAN IMPORT SURPLUS AND CURRENT ACCOUNT, 1980–87



*) Equals civilian import surplus.

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Developments in the civilian import surplus reflected changes in the gap between domestic uses and GDP (see Fig. VII–3; see also Chapter II, Product and Domestic Demand). In 1986 domestic resource uses expanded by 8.4 percent while GDP grew by only 3.3 percent, causing the civilian import surplus to widen to about $1 billion in real terms. A third of this increase was offset by an improvement in the terms of trade. At the same time, a substantial real appreciation[3] was recorded, as prices of imports and exports rose less than those of domestic uses (see Table VII–1 and Fig. VII–2). In contrast, in 1987 domestic uses expanded more slowly, by 5.8 percent, while GDP growth accelerated to 5.2 percent. Consequently, the real-term increase in the civilian import surplus derived from domestic uses was more moderate than in 1986, amounting to some $230 million, and was further aggravated by the deterioration in the terms of trade. A real appreciation continued, but was much more moderate than in the previous year.

The movements in the terms of trade reflected the sharp changes in relative world prices over the last two years. The steep 46 percent fall in the price of fuel imports in 1986 contributed to an improvement of the country's terms of trade. This improvement reversed in 1987, due in part to the recovery of fuel prices, which rose by 22 percent. The terms of trade were also affected by the continued weakening of the U.S.dollar

[3] See note 2, Chapter III, Prices.

Table VII-2
THE BALANCE OF PAYMENTS, 1982–87[a]
($ million, current prices)

	1982	1983	1984	1985	1986	1987
1. Net goods and services account	–4,566	–4,821	–4,768	–3,915	–3,904	–5,825
Private sector	–2,495	–3,015	–2,209	–734	–1,428	–2,058
Public sector[b]	–2,071	–1,806	–2,559	–3,181	–2,476	–3,767
2. Net unilateral transfers[c]	2,605	2,865	3,366	5,075	5,374	4,827
Private sector	1,110	993	823	809	1,159	1,547
Public sector	1,495	1,872	2,543	4,266	4,215	3,280
3. Net current account (1+2)	–1,961	–1,956	–1,402	1,160	1,470	–998
Private sector	–1,385	–2,022	–1,386	75	–269	–511
Public sector	–576	66	–16	1,085	1,739	–487
4. Net medium- and long-term capital[d] flows	1,147	2,340	1,287	80	501	353
Private sector	–115	1,066	183	76	153	331
Public sector	1,261	1,273	1,105	4	348	22
5. Net basic balance of payments (3+4)	–814	384	–115	1,240	1,971	–645
Private sector	–1,500	–956	–1,203	151	–116	–180
Public sector	685	1,339	1,089	1,089	2,087	–465
6. Net short-term capital movements	330	–414	505	–230	–781	852
Nonbanking private sector	278	66	79	–82	–139	108
Public sector	52	–480	426	–148	–642	744
7. Capital movements of the banking system	1,660	252	–107	–4	–19	116
8. Errors and omissions	–257	–788	–793	–605	–179	429
9. Increase (–) or decrease (+) in foreign reserves[e]	–918	565	509	–400	–992	–752

[a] Differences in totals due to rounding.

[b] The public sector deficit on goods and services account is defined as direct defense imports, plus government imports n.e.s., plus net interest paid to rest of world, less surplus on port services (excl. fuel), plus a component of imports of inputs financed by the government.

[c] See Table VII–7 for details.

[d] See Appendix Table VII–A9. Net capital movements of the private sector are the sum of row 3b in Table VII–A9.

[e] Reserves held by central monetary institutions; 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.

against European currencies and the Yen—by an average of 20–40 percent between 1985 and 1987. Price increases in the leading economies did not fall in line with this large depreciation of the dollar, with the result that most of the dollar's depreciation translated into changes in relative prices. This development contributed to a deterioration in Israel's terms of trade over the last two years, since the share of imports from Europe and Japan in total imports is larger than the share of exports to these countries in total exports. In 1986, these effects were outweighed by the fall in fuel prices, allowing the terms of trade to improve, whereas in 1987 the rise in fuel prices compounded the effect of the dollar's fall, causing the terms of trade to deteriorate. Nevertheless, compared with the early 1980s, the terms of trade are still favorable (see Table VII–1).

The depreciation of the dollar also affected Israel's economy through several other channels. It reduced the purchasing power of dollar-denominated unilateral transfers not tied to purchases from the U.S.This was offset in part by the decline in the foreign debt burden (most of which is denominated in dollars), and in the ratio of foreign debt to GDP. The weakening of the dollar also caused difficulties for some exporters, narrowing their profit margins. Nonetheless, so far there have been no signs of trade diversion, and exports to the U.S. rose very considerably, apparently benefiting, among other things, from the free trade agreement between Israel and the U.S. Israel's total exports grew faster than the moderate 4.7 percent expansion—similar to the previous year's exp[ansion— of world trade.

The current account deficit was financed without difficulties; after deducting past payments for defense imports, the remainder was more than covered by net investments from abroad and medium- and long-term loans, so that a $100 million surplus was recorded in the basic account (the current account plus medium- and long-term capital movements).

As long as domestic inflation is higher than abroad, within a fixed exchange rate regime, expectations of devaluation come in waves and cause capital movements to display a cyclical pattern. Thus, 1987 experienced sizeable short-term capital movements. The currency was devalued by about 11 percent against the currency basket in January 1987 and a further 2 percent in the last quarter of the year. Capital imports following the January devaluation until mid-year were estimated at approximately $1 billion. Expectations of devaluation strengthened in the second half of the year, causing a substantial outflow of capital, estimated at $250 million. In early 1988, expectations of devaluation in the near future abated, and since February modest capital imports were again recorded. The changes in domestic interest rates also contributed to the increase in the size of capital movements this year. Thus, after the devaluation in early 1987, interest rates were raised out of concern that price rises might accelerate and increase the real appreciation. Subsequently, interest rates were reduced even when expectations of devaluation rose towards the end of the year.

The ability to set, for considerations of monetary policy, an interest rate higher than that prevailing abroad rests on a comprehensive system of foreign exchange controls. The side effects of these controls are reflected in distortions caused by the imposition of prohibitions and regulations that discriminate between different segments of credit. The foreign exchange controls possibly also contribute to the banking system's power to set higher financial margins (between borrowing and lending rates) than those prevailing abroad. Experience in Israel and other countries teaches that lifting of exchange controls must be cautious and gradual, in step with the domestic financial system's adaptation and preparedness for an easing of controls. The partial reform of the capital market this year was a positive step in this direction. In addition, a low impost was proposed for all segments of capital, but eventually only a surcharge on a relatively narrow credit segment was approved, thereby losing its effect as a non-discriminatory instrument.

It is important to remember that the market for goods is still subject to many restrictions. Success in the use of a fixed exchange rate as the nominal anchor for the domestic price system depends on allowing imports to compete against their domestic substitutes. A further reduction of inflation can therefore be strongly assisted by a further elimination of import restrictions.

THE EFFECT OF DEFENSE IMPORTS AND THEIR FINANCING ON THE IMPORT SURPLUS AND THE CURRENT ACCOUNT

The year-to-year changes in the imports surplus and the current account are to a large extent affected by the timing of the supply of direct defense imports, whereas the payment for these imports do not fluctuate as widely. In previous years these disbursements included, in addition to payments for actual supplies of defense goods, advances on future deliveries. These may be regarded as purchases of goods in process of production. In 1987, in contrast, an exceptionally high level of defense imports was recorded, utilizing advances paid out in the past. Total outlays on defense imports were $125 million lower than in 1986 (the sum of lines 1 and 2). In the last three years payments for defense imports were high compared with earlier years.

US$ millions

	Average 1982–84	1985	1986	1987
1. Direct defense imports	1,312	1,792	1,168	2,437
2. Advances paid for defense goods	127	54	649	–744
3. Import surplus	4,718	3,915	3,904	5,825
4. Adjusted import surplus (3+2)	4,845	3,969	4,553	5,121
5. Current account	–1,773	1,160	1,470	–998
6. Adjusted current account (5+2)	–1,900	1,106	821	–254

2. THE BALANCE OF PAYMENTS IN RECENT YEARS—AN ASSESSMENT

In recent years the various components of the balance of payments have exhibited large annual fluctuations, due to changes in the country's economic policy and developments in the world economy. Between 1980 and 1983 the civilian import surplus rose rapidly, bringing in its wake a deterioration in the current and basic accounts, a steep rise in foreign debt, and large private capital outflows. Although there was an improvement in the import surplus in 1984, private capital outflows mounted, and it became more difficult to finance the balance of payments deficit. A substantial improvement in all balance of payments components (due in large part to the temporary increase in U.S. aid) occurred after the introduction of the stabilization program in July 1985. Towards the end of 1985 and during 1986, when there were signs that the program was succeeding, the economy adjusted to the lower inflation, reduced pressure from the balance of payments, and higher growth of GDP and domestic uses. In 1986 this adjustment took the form of a large expansion of the more flexible domestic demand, and a slower increase of business sector product. This adjustment process speeded up in the course of 1987, with domestic uses continuing to expand, but at a slower pace than in 1986, while GDP grew more rapidly.

In reviewing the course of this development, the examination of discrete annual changes illuminates only one stage in the process; it does not permit a proper assessment from a long-run perspective. Such an evaluation is needed not only for judging where the economy stands now by comparison with earlier years, but particularly in order to define the conditions for maintaining its stability in the years to come.

In order to evaluate the present state of the balance of payments, an attempt will be made to quantify and exclude the transitory factors which affected it in 1987. One substantial correction has already been made above, by adjusting for fluctuations in direct defense imports and referring to an 'adjusted' current account. There are other factors of a transitory nature, but they act in both directions. Most obvious among these are defense imports, which even after their 'adjustment' remain above their multi-annual level.[4] In contrast, private sector unilateral transfers were particularly high in 1987, and apparently comprised a temporary element which reflected the worthwhileness of importing capital; the same considerations also enter the determination

[4] The annual average (1982–86) of direct defense imports is $1,550 million. After deducting from the total military aid the freely convertible portion, which now stands at $450 million, the multi-annual average measured on the basis of financing sources is even less than the above figure. It would therefore seem that defense import outlays in 1987 were some $150–300 million above their permanent level.

of the magnitude of unilateral transfers.[5] On a rough estimate, these factors offset each other, so that the 'adjusted' current account seems a good indicator of the state of the economy in 1987, after allowing for these prominent transitory factors.

The ratio of the 'adjusted' current account deficit to GDP this year was about one percent, compared with an average of 6 percent for the decade ending in 1984. About half of the improvement was attained by a reduction of the civilian import surplus, and the other half was due to increased U.S. grants-in-aid. This change was achieved while GDP growth accelerated, and not as a result of a policy designed to curb demand. In retrospect, it would therefore seem that 1985 was a turning point for the balance of payments since the stabilization program was launched, andafter two years of a current account surplus, the balance of payments position in 1987 was still motre favorable than in the decade prior to the stabilization program.

It may be debatable whether the existing conditions in the balance of payments provide a good starting point for a stable path in the years to come. From the analysis presented below it emerges that, starting from the current position, a stable balance of payments path can be attained, provided that the following conditions are fulfilled:

(a) Total domestic resource uses should grow less than GDP in order to compensate for the declining ratio of unilateral transfers to GDP.

(b) The fall in the ratio of foreign debt to GDP should continue in order to bolster the balance of payments position against internal or external shocks.

Conditions (a) and (b) are easier to fulfil when economic growth is high. In order to attain steady growth, it appears necessary to increase the share of investment in GDP at least for several years (see Chapter II, Product and Domestic Demand). A smaller share of consumption in GDP will help to release the resources required for this purpose.

THE CURRENT ACCOUNT AND THE CIVILIAN IMPORT SURPLUS, 1968–87

(Percent of GNP, annual averages)

	1968–1972	1973–1975	1976–1980	1981–1984	1985	1986	1987
Current account[a]	–8.1	–10.4	–4.5	–6.7	4.8	2.9	–0.8
Civilian import surplus	10.8	16.3	11.5	12.4	9.3	9.7	10.1
Public sector interest payments, net	0.9	0.7	1.6	2.5	4.8	3.7	3.2
Civilian import surplus, excl. public sector interest payments	9.8	15.7	9.9	9.9	4.5	6.0	6.9

[a] Adjusted from 1980 for advances on defense imports; see box.

[5] The steady unilateral transfers to the private sector were estimated, according to the second half of the year, at an annual level of $1.3 billion. Approximately $250 million were thus deducted from the recorded 1987 level.

We may first examine the development of the current account, as derived from total resource uses—GDP and unilateral transfers. When domestic resource uses and GDP grow at the same rate, the import surplus, which is the difference between them, remains stable in proportion to GDP. On the other hand, if unilateral transfers, which finance a substantial portion of the import surplus, are not expected to increase, or at least not at the same rate as resource use and GDP, a steady deterioration in the current account, a rise in the external debt and a deviation from stable growth must be expected. It follows that in order to stay on a stable balance of payments path, total domestic uses must expand more slowly than GDP, enough to compensate for the decline in unilateral transfers as a ratio to GDP. Thus, after the considerable decrease in the weight of public consumption in GDP—from 41 percent in 1980 to 36 percent in the last three years—it is necessary to carefully maintain a further moderate reduction of the share of public consumption in GDP, in order to prevent a continuing deterioration in the current account. The higher the GDP growth rate, the easier it will be to attain this objective (see below).

The external debt/GDP ratio is a conventional indicator for the assessment of stability in the development of the balance of payments. Disregarding temporary increases in response to unexpected shocks, one reason for an increased accumulation of foreign debt may be a desire to profit from good investment opportunities; another reason may be the wish to advance consumption in expectation of future growth. Debt accumulation motivated by these two factors will be accompanied, with little time lag, by GDP growth, and will therefore lead to only a temporary worsening of the debt/GDP ratio. But a substantial part of past external debt accumulation was due to the continued financing of public spending by borrowing abroad. This trend was arrested when the U.S. converted the loans by which it provided military aid to Israel into outright grants. The debt/GDP ratio has improved considerably during the last three years, falling from 80 percent in 1984 to some 57 percent in 1987. Although about half of this improvement was due to a real appreciation and changes in cross rates abroad, the other half resulted from real GDP growth. This index therefore also points to an improvement in the balance of payments position. Nevertheless, the debt/GDP ratio is still high by international standards, and may aggravate financing difficulties in the event of internal or external shocks. It is therefore necessary to achieve stable GDP growth in the next few years, in order to permit a decline in the debt/GDP ratio.

We have so far focused on the necessary conditions regarding total domestic resource uses for maintaining a steady path in the development of the balance of payments position, taking the present state as the point of departure. We have twice mentioned that the higher GDP growth, the easier it will be to meet these conditions. Accordingly, the low ratio of investment to GDP during the last three years (see Fig. VII–3) is a cloud hanging over the stability of the balance of payments position in the next few years. Furthermore, it may be argued that the recent decline in the share of investment facilitated the improvement in the current account in the last three years, and is therefore a temporary phenomenon. However, an examination of the structure of investment reveals that this decline was primarily concentrated in housing. Among the exogenous factors that determine the size of housing investment, it is possible to list factors which also influence private saving, particularly demographic factors. It is therefore possible that a cyclical upturn in housing investment will be accompanied in the future by a matching rise in the private saving rate, and will not contribute to a balance of payments deterioration (for a more detailed discussion, see Chapter II, Product and Domestic Demand, and Table II–1c).

Even so, it does not appear to be sufficient to maintain the ratio of fixed investment to GDP at the level achieved at the beginning of the decade; it needs to be emphasized that increasing growth-producing investments is important for future improvements in the balance of payments. The preferable way of attaining such an increase in investment is by reducing the share of consumption in GDP so as to release domestic resources for investment. As stated earlier, a temporary rise in the external debt to GDP ratio is justifiable also in order to provide the economy with investment resources not available from domestic savings. Improvements in the domestic capital market, together with some exposure of the economy to the international capital market, may therefore augment the supply of capital required for investment. Such a liberalization is also important because it would compel domestic producers and investors to adapt their economic decisions to the price of capital which the economy faces.

The balance of payments position may also be evaluated from another angle, namely the development of relative prices of tradeable goods (exports and domestic substitutes of import goods) as compared with non-tradeable goods. It is difficult to establish the relative prices that accord with the equilibrium point in the balance of payments. It has nevertheless been suggested that a substantial real appreciation may indicate a deviation from equilibrium, so that the 15 percent decline in export and import prices relative to those of domestic uses in the last two years indicates a worsening of the state of the economy.

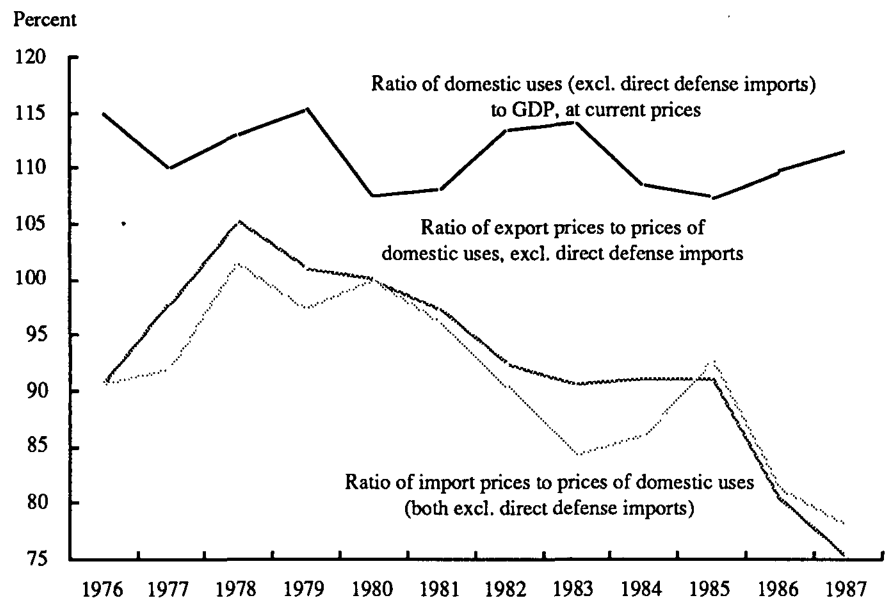
By itself, a real appreciation may reflect diverse developments. One possibility is that it will generally accompany an expansion of domestic uses higher than GDP growth, even when there has been no change in the structure of resource uses and GDP, as between tradeable and non-tradeable goods. In this case, when the development is not of a temporary nature, stability in the payments balance is undermined (even assuming that unilateral transfers increase in step with GDP growth). The gap between domestic uses and GDP widened in 1986, but became very small in 1987.

A second possibility is that a real appreciation may reflect a change in the composition of domestic uses, with higher demand for non-tradeable goods. If the gap between total domestic uses and GDP (tradeable and non-tradeable goods) has not increased, the shift may be an adjustment to a new pattern of tastes, and balance of payments equilibrium will be restored at a lower real exchange rate. In this case the real appreciation is no indication for a deviation from equilibrium.

A third case is that of a real appreciation taking place while the production capacity of tradeables rises more rapidly than that of non-tradeables. In this case, as in the previous one, the balance of payments may improve while a real appreciation develops. An examination of the composition of investments in recent years lends support to such a hypothesis: Investment in industry has had the highest growth rate. As a result, the capital stock in the industries producing tradeable goods has in recent years grown by 1–1.5 percentage points more than in branches producing non-tradeables. This suggests that the sector producing tradeable goods is likely to grow faster than other sectors (see Chapter II, Product and Domestic Demand).

The fourth possibility is the development of a real appreciation combined with a reduction in the rate of unemployment. When there is unemployment in the economy, relative prices have no precise meaning, so that a real appreciation has no meaning, and therefore cannot be interpreted unequivocally as a deterioration in the balance of payments. This was the case in the last three years, when the unemployment rate rose in 1985, to decline again in the last two years.

Figure VII–2
DOMESTIC USES, GDP, AND RELATIVE PRICES, 1976–87



Note: Until 1979, calculated according to the old SNA definitions.

Since there is evidence for some of these possibilities, it is difficult to ascribe the real appreciation in 1987 to only one principal factor. Moreover, Fig. VII–2 shows a clear trend of a real appreciation over time, despite the absence of a trend in the ratio of domestic uses to GDP. This finding is more consistent with a change in the structure of production and demand. It is therefore difficult to evaluate the balance of payments position by analyzing only the real exchange rate. It would seem that an analysis of total resource uses and their composition as against the development and structure of GDP leads to more definite conclusions, as summarized in the introduction of this discussion.

It is not our purpose to provide an exhaustive analysis of all the complex of factors which could improve the economy's performance. This partial analysis shows the importance of continuing to curb public consumption relative to GDP, as the key to balance of payments stability in the years to come. This development would also further contribute to bolstering confidence in economic policy, prevent private capital exports, and thus maintain the favorable conditions which the economy has enjoyed in the last three years for financing the payments balance.

3. THE CURRENT ACCOUNT

In 1987, the current account, which had been in surplus in the two preceding years, recorded a deficit of nearly $1 billion. However, the 'adjusted' current account (see box) shows a deficit of about $250 million, as compared with a surplus of approximately $820 million in 1986. This deterioration in the current account is not surprising because part of the improvement in the two preceding years was due to temporary factors, such as the one-time grants-in-aid provided by the U.S.

The current account deficit is the difference between total national expenditure and the income available to the country, which includes the gross national product valued in foreign currency and unilateral transfers from abroad. An increase in the current account deficit may therefore result from domestic demand expansion outpacing GDP growth, a decline in unilateral transfers or a worsening of the terms of trade—four interacting variables. In addition, a rise in world prices (with unchanged terms of trade) causes the current account deficit to widen in terms of foreign currency.

In 1987 unilateral transfers to the public sector contracted by $935 million (mainly because the U.S. emergency aid of $750 million in each of the two preceding years were one-time grants), while unilateral transfers to the private sector increased by some $400 million. Total domestic resource uses, excluding direct defense imports, rose in 1987 by 5.8 percent, as against a 5.2 percent growth of GDP (See Chapter II, Product and Domestic Demand, and Fig. VII–3[6]). This gap increased the volume of the civilian import surplus: civilian imports (excluding capital services) expanded by 11.6 percent while exports (excluding capital services) grew by 10.5 percent (see Table VII–3). When an economy runs an import surplus, these differential growth rates of imports and exports imply a slight increase in the import surplus.

However, the civilian import surplus, excluding capital services, increased by some $730 million. The rest of the increase in the surplus, beyond its volume growth, was due to higher world prices, with dollar prices of imports and exports rising as the U.S. dollar weakened. In an economy running an import surplus, a rise in dollar prices causes it to widen even if import and export prices rise equally. In addition, however, the terms of trade deteriorated as import prices rose by about 10 percent while export prices went up only 7 percent. The increase in the import surplus was therefore composed as follows: some $230 million[7] were due to the difference between the growth of domestic uses as against that of GDP, about $110 million resulted from price rises, and approximately $390 million were caused by the deterioration of the terms of trade.

* * *

Developments in 1987 were shaped by the consequences of the stabilization program launched in July 1985. The stabilization of the exchange rate was central to the program, and developments in the economy must be examined against this background. With the adoption of the program, domestic demand contracted sharply, with the effect of a further improvement in the civilian import surplus—declining from about $3.3 billion in 1984 to some $2.1 billion in 1985. With cumulating signs of the stabilization program's success—a sharp reduction of inflation, improvement of the balance of payments, and GDP growth—there began, towards the end of 1985 and during 1986, a process of adjustment to a long-term path of higher GDP and aggregate demand. Demand, being more elastic, adjusted rapidly, and the civilian import surplus rose in 1986 to about $2.7 billion. A substantial proportion of the incremental demand went to import products which have no close domestic substitutes. In addition, the structure of demand changed and the domestic production system found it difficult to adapt quickly to these changes (see Chapter VI, The Principal Economic Sectors). In the course of 1987 the adjustment process gathered speed, as domestic resource uses continued to expand, albeit more slowly than in 1986, while GDP growth accelerated, so that the total civilian import surplus increased by $650 million. The acceleration in

[6] The figure describes the development of domestic demand relative to GDP since the early 1970s. The illustration is discussed in previous Annual Reports.

[7] In an economy running an import surplus, this increases even when demand and GDP grow at the same rate.

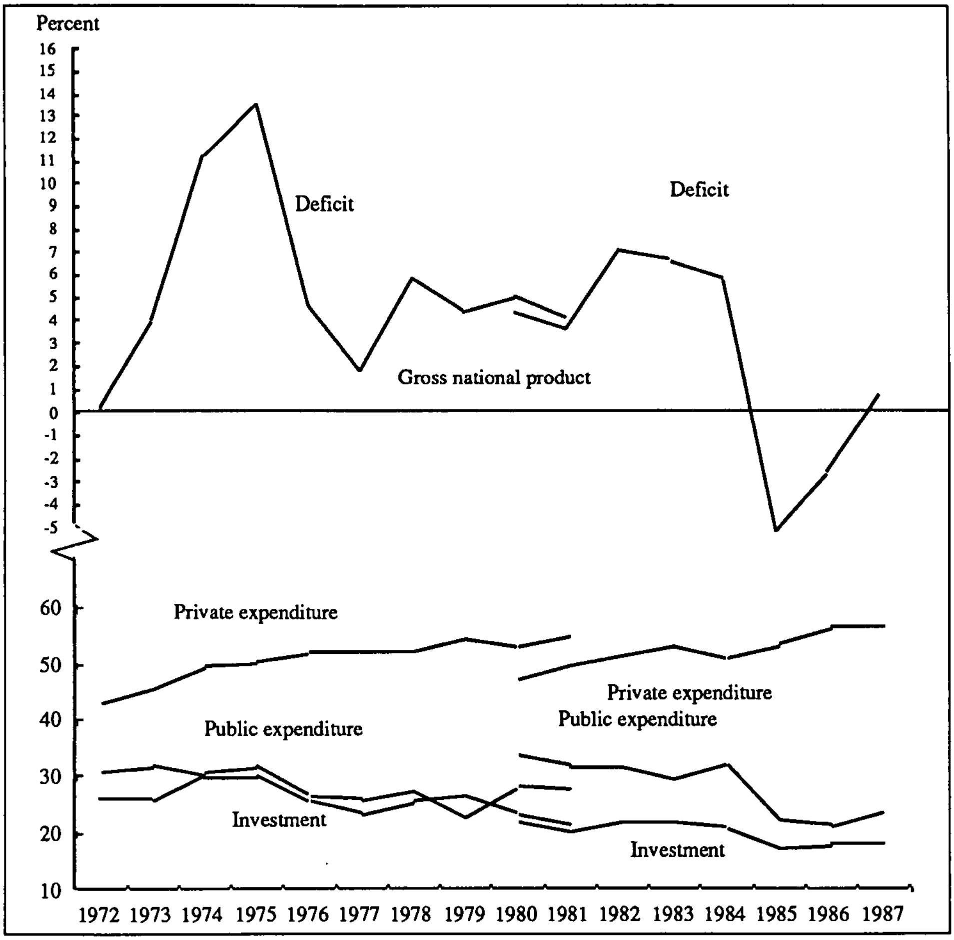
GDP growth was due to several causes: the lowering of inflation, the cut in corporate taxes, the capital market reform, and others (see Chapter II, Product and Domestic Demand). In addition, the domestic production system began to adapt to the changing composition of demand. Foreign trade data reveal a further factor: in the last two years prices of imported production inputs (excluding fuel and diamonds) rose less than those of imported finished goods and domestic products. In 1987 the dollar prices of these inputs went up by some 6 percent, equivalent to some 13 percent in sheqel terms, while prices of imported final goods rose by some 24 percent in terms of local currency, and the wholesale price index of industrial output rose by 18 percent. These price movements indicate that imported inputs have become relatively cheaper.[8] Furthermore, fuel prices dropped steeply in 1986 and although they rebounded in 1987, their level remained low compared with 1980–85. The resulting fall of production costs facilitated output expansion, and GDP growth together with an expansion of trade has indeed been experienced by some countries. These factors may have facilitated the acceleration of GDP growth in Israel, especially in 1987.

Together with the modest increase of the real import surplus, the country's foreign trade expanded as both imports and exports rose substantially. This trade expansion indicates a growing propensity of producers to specialize as well as greater discrimination by consumers with regard to quality. Both of these factors affect the economy's income and the public's welfare. The steep rise in the volume of foreign trade, particularly of exports, is especially remarkable in view of the lower profitability of exports to dollar markets and adverse domestic developments: real wages, which were eroded in early 1987 as a result of the January devaluation, rose again later in the year, with nominal wage increases exceeding price rises. In the last two years taken together, real unit wage costs in industrial exports rose some 27 percent (see Table VII–8 and the discussion below of the relevant indexes of foreign trade).

The handsome growth of exports is somewhat puzzling in view of the cumulative deterioration of profitability, and no single explanation for it can be offered. It is plausible that several factors were at work: Developments in world markets in the last two years were uneven; some countries experienced an impressive growth of trade while others recorded stability or even a slowdown. The total growth rate of world trade was stable (see section 5 below). It would seem that Israel, like other countries, benefited from the cheapening of commodities, and was affected by the changes in cross rates. These two factors operated both on the supply and the demand side, with trade increasing in some of Israel's markets and an enhanced ability to compete against European countries in various other foreign markets—a competitiveness that was further enhanced by the trade agreements.

[8] This also emerges from the discussion in Chapter VI, the section on industry. Table VI–10 shows that prices of inputs relative to output declined by 1.8 percent; in this table inputs include both imports and locally produced intermediates.

Figure VII-3
TOTAL NATIONAL EXPENDITURE BY COMPONENTS AND THE 'ADJUSTED' CURRENT ACCOUNT DEFICIT, 1972–87
(Percent of GNP, at the official exchange rate)



NOTES: The current account deficit is calculated at the official exchange rate. Private consumption = private consumption, less unilateral transfers from abroad to the private sector. Public expenditure = total public expenditure, less unilateral transfers from abroad to the public sector; adjusted for advances on defense supplies.Investment = gross investment in fixed assets and inventories. (Attention is called to a break in the series which stems from the use of the old SNA until 1981, while the new SNA is from the end of 1980.) We do not argue that unilateral transfers from abroad to the private sector necessarily finance consumption; the intention is merely to emphasize the distinction between private and public consumption on the one hand, and investment on the other, since the latter contributes to future GDP growth.

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

Table VII-3
GOODS AND SERVICES ACCOUNT, 1984–87[a]

	$million				Percent annual change					
					Price			Volume		
	1984	1985	1986	1987	1985	1986	1987	1985	1986	1987
Imports										
Goods, excl. fuel and diamonds[b]	5,298	4,971	6,385	7,988	–1.9	9.0	9.8	–4.4	17.9	14.0
Fuel	1,593	1,510	924	1,148	–6.2	–46.0	22.0	1.1	13.3	1.8
Diamonds	880	1,168	1,598	1,901	1.5	10.0	3.5	30.8	24.3	14.9
Services, excl. capital services[b]	2,837	2,406	2,599	3,064	1.6	7.0	9.6	–16.6	1.0	7.6
From Judea-Samaria and Gaza District	554	482	727	973	–1.9	37.8	20.5	–11.3	9.4	11.1
Subtotal, civilian imports excl. capital services	**11,162**	**10,537**	**12,233**	**15,074**	–1.4	2.1	10.4	–4.3	13.7	11.6
Capital services	2,966	2,772	2,563	2,513						
Direct defense imports	1,462	1,828	1,202	2,471						
Total	**15,590**	**15,138**	**15,999**	**20,057**						
Exports										
Goods, excl. diamonds[b]	4,531	4,739	5,211	6,099	–0.2	2.8	8.5	4.8	7.0	7.8
Diamonds	1,035	1,263	1,665	2,059	–3.9	4.4	1.4	26.9	26.2	22.0
Services, excl. capital services[b]	3,306	3,448	3,398	4,052	–0.7	7.3	8.4	5.0	–8.1	10.0
To Juda-Samaria and Gaza District	759	733	970	1,148	–8.5	15.7	10.9	5.6	14.3	6.7
Subtotal	**9,631**	**10,184**	**11,244**	**13,359**	–1.5	5.4	7.5	7.3	4.8	10.5
Capital services	1,192	1,039	851	875						
Total	**10,823**	**11,223**	**12,095**	**14,233**						
Import surplus[b]										
Goods, excl. fuel and diamonds	767	232	1,173	1,888						
Current surplus of diamonds	156	95	67	158						
Services, excl. capital services[b]	469	1,042	799	988						
Civilian, excl. capital services	1,531	354	989	1,715						
Net capital imports	1,774	1,733	1,712	1,638						
Total, civilian import surplus	3,305	2,087	2,701	3,353						
Total import surplus	**4,767**	**3,915**	**3,904**	**5,824**						
Trade deficit	2,204	1,647	2,031	2,878						

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

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

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

Domestic developments also had their impact on exports. GNP growth in 1987 was impressive, and may have been associated with structural change and higher growth in the production of goods defined as tradeables in the world market (exports and import substitutes), and export goods in particular. This implies greater specialization, which expands foreign trade. One indicator of growth in the export industries may be seen in the multi-annual growth of exports, excluding capital services, at an average annual rate of 6 percent in 1981–87, as against an average annual GDP growth of 3.2 percent in the same period. In comparing the two growth rates, it should be kept in mind that exports account for 40 percent of GDP (see Chapter II, Product and Domestic Demand, Table II–1).

This direction of growth may have received a push from the existing spread of interest rates. Thus, for example, the Law for Encouragement of Investment channelled credit at relatively low interest rates to preferred sectors, and may have increased investment in them. A preliminary examination of investment and changes in the capital stock by industries shows that in recent years the capital stock in industries producing tradeables has increased more than in other industries. This points to a higher increase of the production capacity of tradeables (see Chapter II).

The growth of exports in 1987 was marked by embracing most of its sectors. Industrial exports, excluding diamonds, increased by 10 percent, and diamond exports by 22 percent, but agricultural exports fell by 6.5 percent. Exports of services, excluding capital services, also recorded an impressive 10 percent expansion, after having declined by some 8 percent in 1986.

Side by side with the growth of exports there was also a rise in the volume of imports. Unlike in the previous year, the increase covered all components of imports, albeit not at a uniform rate. Merchandise imports, excluding fuel and diamonds, increased by 14 percent in volume; fuel imports rose by 2 percent, following a 13 percent expansion in 1986; imports of diamonds were 15 percent higher, compared with a 24 percent rise in 1986; and imports of services, excluding capital services and Judea–Samaria and Gaza, increased by 8 percent after having remained stable in 1986.

The composition of imports by final economic destination summarizes the distribution of imports of intermediates and final goods for each use (see Appendix Table VII–A1). The steep rise in direct defense imports reduced the share of other economic destinations in total imports. A similar computation of the composition of civilian imports by final destination shows a rise in the shares of private consumption, fixed investment and exports, at the expense of public consumption other than defense and capital services—a development that accords with the changes in domestic demand.

The real appreciation which occurred in 1987, together with the deterioration in the relevant indexes, might make it seem that prices of imported goods declined relative to locally produced goods. However, when the implicit national accounts prices of private consumption are compared with prices of imported consumer goods (taking

Table VII–4
CIVILIAN MERCHANDISE IMPORTS BY ECONOMIC DESTINATION, 1984–87[a]

	$ million				Percent annual change[b]					
					Price			Volume		
	1984	1985	1986	1987	1985	1986	1987	1985	1986	1987
Consumer goods	657.0	621.0	1,029.4	1,333.8	–0.8	18.8	14.4	–4.7	39.5	13.2
Of which: Durables	256.4	231.7	454.0	625.5	4.1	27.7	19.1	–13.2	53.4	15.7
Capital goods	1,572.4	1,413.7	1,604.1	2,141.8	4.4	17.1	15.5	–13.9	–3.1	15.6
Of which: Equipment, machinery and instruments	1,246.9	1,227.1	1,295.2	1,539.3	3.6	14.1	13.6	–5.0	–7.5	4.6
Intermediates	6,004.5	6,161.7	6,846.2	8,221.7	–3.7	–6.5	7.7	6.6	18.8	11.5
Of which: Fuel	1,592.8	1,510.2	924.3	1,147.8	–6.2	–46.0	22.0	1.1	13.3	1.8
Raw and polished diamonds, net	879.9	1,168.3	1,597.9	1,900.9	1.5	10.0	3.5	30.8	24.3	14.9
Other	3,531.8	3,483.2	4,324.0	5,173.0	–4.3	4.4	6.5	3.0	18.9	12.3
Goods n.e.s., less returned imports	–161.8	–175.5	–194.7	–246.3						
Total (net) foreign trade statistics	**8,072.1**	**8,020.9**	**9,285.0**	**11,451.0**	–2.3	–1.0	9.8	1.7	16.9	12.3
Balance of payments adjustments	–301.5	–371.6	–378.3	–414.8						
Imports from Judea-Samaria and the Gaza District	185.3	181.3	274.6	303.8	2.8	20.1	4.7	–4.8	26.2	5.7
Total civilian goods imports, net, according to balance-of-payments definition (c.i.f.)	**7,955.9**	**7,830.6**	**9,181.3**	**11,340.0**	–2.1	–0.5	9.7	0.6	17.8	12.6
Total, net, excluding fuel, diamonds, and Judea-Samaria and the Gaza District	**5,297.9**	**4,970.8**	**6,384.5**	**7,987.5**	–1.9	9.0	9.8	–4.4	17.9	14.0

[a] Imports c.i.f., excluding direct defense imports.

[b] Rates of change were calculated prior to rounding.

SOURCE: Central Bureau of Statistics.

account of changes in exchange rates and taxes), it appears that there was virtually no difference between these price movements. An examination of the comparative prices of capital goods shows a similar picture.

The expansion of foreign trade was accompanied by price increases—some 10 percent for civilian imports less capital services and about 7 percent for exports less capital services. The price rises were due, among other things, to the strengthening of the European currencies, which also had its share in worsening the terms of trade due to the differences between the countries of origin of imports and the destinations of exports: over 60 percent of Israel's total merchandise imports come from Europe, but only 40 percent of her exports go there (se Appendix Tables VII–A2 and VII–A3). The deterioration in the terms of trade may also have been due to the considerable increase in the volume of trade, insofar as Israel's imports or exports could have an effect on world market prices. The worsening of the terms of trade for merchandise except fuel and diamonds expressed itself in an export price rise of about 8 percent, as against a 10 percent increase in import prices. The 22 percent price rise for fuel further aggravated the deterioration in the terms of trade. In view of the sharp changes in the terms of trade in recent years (see Table VII–1) it is difficult to assume that individuals regarded this year's deterioration as a permanent change; it is therefore reasonable to assume that they have not yet responded to it.

Unilateral Transfers

In 1987 total net unilateral transfers declined by $550 million; transfers to the public sector contracted by $935 million, while transfers to the private sector rose by $390 million (see Table VII–7).

The major source of public sector transfers is U.S. aid (see Appendix Table VII–A8), which has in recent years comprised $1.8 billion a year as a military grant-in-aid and another $1.2 billion as a civilian grant. In the two preceding years Israel received, in addition, an emergency grant of $750 million a year, as special support for the stabilization program. This grant was among the temporary factors that accounted for the large current account surplus in 1985–86.

Since 1985 all of the military aid has been given as a grant, whereas in the preceding decade most of it was extended in the form of long-term loans. The financing of defense consumption from loans resulted in an annual increase of about $1 billion in the debt to the U.S., until the debt balance rose to some $10 billion. The service of this debt, on account of principal and interest, mounted rapidly in recent years, with a corresponding increase in the civilian grant provided by the U.S. A comparison of the civilian grant with the amounts of capital service to the U.S. government between 1975 and 1987 shows that the major part of the civilian grant was repaid to the U.S. government as payments of principal and interest on the debt, and the remaining balance of civilian

Table VII-5
COMMODITY EXPORTS, BY SECTOR, 1984–87[a]

	$ million[c]				Percent annual change[b]					
					Price			Volume		
	1984	1985	1986	1987	1985	1986	1987	1985	1986	1987
Agricultural exports	529	469	560	613	–3.2	5.8	17.1	–8.5	13.0	–6.5
Citrus	116	172	175	206	45.2	5.5	14.0	1.9	–3.6	3.0
Other	412	296	385	408	–19.0	5.9	18.5	–11.2	22.7	–10.6
Industrial exports[d]	4,034	4,350	4,709	5,551	0.1	2.5	7.5	7.7	5.7	9.6
Metals, machinery and electronic equipment	1,760	1,928	2,204	2,430	0.6	5.3	6.1	8.9	8.5	3.9
Other industrial exports	2,274	2,421	2,505	3,121	–0.3	0.1	8.7	6.8	3.4	14.6
Diamonds, net	1,035	1,263	1,665	2,059	–3.9	4.4	1.4	26.9	26.2	22.0
Ships and aircraft	32	10	5	10						
less Returned exports	8	6	7	10						
Total exports, net, foreign trade statistics	**5,622**	**6,084**	**6,933**	**8,222**	–1.0	3.2	6.7	9.3	10.4	11.2
Balance of payments adjustments	–56	–82	–57	–64	...	...	...	...	...	...
Exports to Judea-Samaria and the Gaza District	623	600	798	928	–9.8	15.1	10.7	6.9	15.6	5.0
Total, net, balance of payments definition	**6,189**	**6,602**	**7,674**	**9,086**	–1.9	4.3	7.1	8.7	11.5	10.6
Total, net, excl. diamonds and exports to Judea-Samaria and Gaza	**4,531**	**4,739**	**5,211**	**6,099**	–0.2	2.8	8.5	4.8	7.0	7.8

[a] Exports f.o.b.

[b] Rates of change were calculated prior to rounding.

[c] Differences in totals are due to rounding.

[d] Excluding diamonds, ships and aircraft.

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

aid amounted to only $50–200 million a year (except in 1983). Until recently the repayment of the debt to the U.S. was therefore financed by the civilian grant; it is plausible that this debt burden in fact served partly as a justification for this grant. Nevertheless, the debt accumulated to $10 billion, carrying an average interest of 10 percent per annum. This itself is a heavy burden for a long time in the future, representing more than half of Israel's total net foreign debt. The change in the form of the aid—grants instead of loans—was an important factor in the stabilization of the country's net foreign indebtedness in the last three years.

Although the military aid granted for U.S. fiscal years, which begin in October, has been constant in recent years, it is not utilized at an even rate in each quarter. Since its receipt is recorded for calendar years, the record shows year-to-year fluctuations.

Table VII–6
SERVICES ACCOUNT, 1984–87

	$ million[a]				Percent annual change[b]		
	1984	1985	1986	1987	1985	1986	1987
Imports							
Transport	1,077	947	909	1,038	–12.0	–4.1	14.2
Tourism	726	550	800	999	–24.3	45.5	24.9
Insurance	39	133	71	73			
Capital services	2,966	2,772	2,564	2,513	–6.5	–7.5	–2.0
Other services	1,273	972	1,180	1,518	–23.7	21.4	28.6
Government services n.e.s.	92	106	93	107			
Total	**6,172**	**5,479**	**5,615**	**6,246**	–11.2	2.5	11.2
of which: From Judea-Samaria and the Gaza District	369	301	453	670	–18.4	50.3	47.9
Total excl. Judea-Samaria and the Gaza District	**2,837**	**2,406**	**2,599**	**3,064**	–15.2	8.0	17.9
Exports							
Transport	1,314	1,324	1,351	1,533	0.8	2.0	13.5
of which: Freight charges on imports (Israeli carriers)	312	306	358	423	–1.6	17.0	18.1
Tourism	1,040	1,101	972	1,347	5.9	–11.8	38.6
Insurance	–18	16	23	32			
Capital services	1,192	1,039	851	875	–12.8	–18.1	2.8
Other services	1,083	1,124	1,203	1,332	3.7	7.0	10.8
Government services n.e.s.	24	16	22	28			
Total	**4,634**	**4,621**	**4,421**	**5,147**	–0.3	–4.3	16.4
of which: To Judea-Samaria and the Gaza District	136	133	172	220	–2.1	29.0	28.0
Total, excl. Judea-Samaria and the Gaza District	**3,306**	**3,448**	**3,398**	**4,053**	4.3	–1.5	19.3
Deficit on services account	1,538	858	1,194	1,099	–44.2	39.1	–8.0
Net imports of capital services	1,774	1,733	1,712	1,638	–2.3	–1.2	–4.3
Surplus on services account excl. Judea-Samaria and the Gaza District	470	1,042	799	988	122.0	–23.4	23.7

[a] Differences in totals are due to rounding.
[b] *Rates of change have been calculated from less rounded figures.*

SOURCE: Central Bureau of Statistics.

Thus, the grant actually utilized in 1987 declined by $90 million compared with 1986. In addition, in 1987 and 1986 loans of $270 million and $400 million were received, in the framework of utilizing military aid grants approved before 1985.

The second major component of unilateral transfers to the public sector is the transfers of the National Institutions out of United Jewish Appeal funds. In recent years these

Table VII-7
UNILATERAL TRANSFERS, 1978–87[a]
($ million)

	Average, 1978–82	1983	1984	1985	1986	1987
Private sector						
Personal restitutions from Germany	437	374	323	328	424	531
Personal remittances	544	553	425	367	593	788
of which: Immigrants	215	230	158	133	318	460
Others	329	323	267	234	277	328
Personal transfers in kind	25	21	20	16	21	24
Transfers of private nonprofit institutions	198	196	190	170	186	290
Private transfers to abroad	–95	–152	–136	–73	–65	–86
Total private sector, net	1,106	993	823	809	1,159	1,547
Public sector, net						
Transfers of national institutions	321	319	327	397	411	314
Intergovernmental transfers[b]	1,283	1,554	2,215	3,869	3,804	2,966
Total public sector, net	**1,604**	**1,873**	**2,542**	**4,266**	**4,215**	**3,280**

[a] Differences in totals are due to rounding.
[b] Includes military and economic grants.

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

transfers have ranged between $320 and $410 million; in 1987 they declined by $100 million from the peak they reached the previous year.

Unilateral transfers to the private sector rose in 1987 to an exceptionally high level—more than $1.5 billion. In 1977–82 these transfers had been constant, at $1.1–$1.2 billion; in 1984–85 they declined to approximately $800 million, and returned in 1986 to the level of the beginning of the decade. A further large increase in these transfers was recorded in 1987. About a third of them is denominated in Deutschmarks (restitution payments), so that the weakening of the dollar in the last two years, like its appreciation in earlier years, explains part of the changes in the total of these transfers in these years. But even allowing for this factor, it still appears that these transfers fell sharply in 1983–85, and posted a large increase in the last two years. This may hint that the level of private unilateral transfers is highly affected by considerations of the worthwhileness of importing capital to Israel. Thus, from 1983 until mid-1985 private unilateral transfers shrank, while transfers to abroad rose, in view of the prevailing sense of crisis in the balance of payments and the public's fear that financial assets might be taxed. A turnaround came in mid-1985, after the stabilization program. The calm attained in 1986 led to an increase in unilateral transfers, back to their average level in the beginning of the decade; in 1987 there was a further substantial rise, mainly in the first half of the year, when the level of transfers stood at $1.7 billion in annual terms. This declined in the second half of the year to $1.3 billion in annual terms—a decrease that accords with the development of private sector capital movements (see below), and which highlights that the considerations determining the size of capital imports are also important in setting the level of the private sector's unilateral transfers.

4. THE CAPITAL ACCOUNT AND THE FOREIGN DEBT

The financing requirements of the current account, excluding past payments for direct defense imports, amounted in 1987 to some $250 million (see box above). In view of this favorable situation the speculative nature of the wide swings of capital movements during the year stands out particularly starkly. Private sector capital imports are estimated at about $1.1 billion in the first half of the year, as against capital outflows estimated at approximately $250 million in the second half of the year, mainly in the last quarter.

Total net capital inflows during the year exceeded the current account's financing reserves and gross foreign debt (see Appendix Table VII–A3). The parallel rise of reserves and gross debt, for the second year running, is partly explained by the considerable changes in exchange rates in these years, but even after allowing for the resulting revaluation, the pattern remains the same—a large increase of both reserves and gross foreign debt.

Considering that holding of reserves financed by debt is not costless, we shall examine its causes, which changed from year to year. This requires distinguishing between the transactions of the public sector in the external current and capital accounts, and the activities of the private sector. Such a distinction is both conceptually and statistically difficult; it must therefore be regarded as no more than an approximation to actual developments (see Table VII–8)[9] The detailed analysis of capital requirements, leading to a rise of approximately $1.1 billion in the foreign exchange movements according to this breakdown is as follows: In 1985 the public sector accumulated a large current account surplus, repaying the entire short-term debt for this period, and using the rest to increase the foreign currency reserves. This increase

[9] Two qualifications should be emphasized: (a) the distinction between the import surplus of each sector in Table VII–2 is based, among other things, on the estimate of direct government imports. This estimator is less reliable than the data on the capital account as recorded by transacting sector. Moreover, direct government imports are not to be seenas an estimator of the government's impact on the current account, since the influence of the government's domestic activity on the current account is not less important. (b) In addition to foreign currency purchases from the Bank of Israel, there are further foreign currency transactions between the public and private sector. In the absence of direct data on these, they are included among 'errors and omissions' of the separate balances, and cause this item in them to be high. This year we have changed the definitions in Table VII–8. Having concentrated on capital movements, we included some inter-sector transactions as adjustments to the 'current account' row. These data should therefore not be used as estimating the transactions of the two sectors in their trading accounts. We have also deducted the advances on future supplies of defense matériel (see box above).

was important for strengthening confidence in the stabilization program, and in view of the private sector's increased purchases of foreign currency from the Bank of Israel. These purchases were $900 million higher than the deficit in the private sector's basic account (the current account plus net investment from abroad and long-term loans). Private sector capital movements calmed down in 1986 and expectations of devaluation abated, but continued uncertainty as regards the stability of the exchange rate prevented the large capital inflows called for by the gap that had opened between domestic and foreign interest rates. The private sector's foreign currency acquisitions were therefore in accordance with the deficit in its basic account. In 1986 the public sector's basic account surplus was used for further greatly increasing the foreign exchange reserves, both for the sake of bolstering domestic and foreign confidence, and because of the inelastic structure of the foreign debt, which was all medium- and long-term. The public sector's basic account surplus declined in 1987, but remained high enough to finance the basic account deficit of the private sector. However, as a result of the gap between domestic and foreign interest rates and, after the January devaluation, the fading expectations of another devaluation in the near future, the private sector financed its deficit by direct capital imports, and had almost no need to purchase foreign currency from the Bank of Israel. Thus, in contrast to earlier years, almost the entire surplus in the public sector's basic account accumulated in the foreign currency reserves.

Despite the substantial rise in the dollar value of the foreign currency reserves in 1987, relative to imports their level remained unchanged (see Appendix Table VII–A11). The level of foreign reserves actually held in 1987 can be justified on various grounds, but financing a higher level of reserves by high domestic interest rates so as to attract private capital imports was more expensive for the economy and the government than had it borrowed directly abroad. In any event, domestic interest rates were not set according to these considerations (see above, and also Chapter VIII, Money and Capital Markets), and the increase in the reserves through private capital imports was in fact a result of monetary policy rather than a consideration that guided it.

The large capital inflows that started immediately after the January 1987 devaluation began to taper off in the third quarter of the year, and in the fourth quarter, as expectations of devaluation mounted, there was a reversal to capital outflows. These continued in January 1988, but the data for February and March indicate a renewal of capital imports, albeit on a smaller scale than in early 1987. Other indicators (such as the black market dollar premium) also point to a fading of expectations of a devaluation in early 1988, but remain at a level still above that prevailing after the January 1987 devaluation.

Cyclical capital movements are a corollary of a fixed exchange rate regime, as long as domestic inflation is higher than abroad. This may be the price that has to be paid, in Israel's present economic circumstances, for the advantages of such a regime. The damage done by capital movements reflects itself in instability in money markets: capital inflows increase liquidity and depress domestic interest rates, and capital outflows contract liquidity, cause a drain on the foreign currency reserves and therefore pressures for a nominal devaluation. Monetary policy acted to bring about a rise in interest rates when there were capital inflows, in order to limit their consequences—domestic demand expansion and real appreciation; in the course of the year efforts were made, in view of the high level of interest rates, to bring them down even when there were capital outflows. However, the size of capital movements is not only influenced by expectations of devaluation but also by the overall gap between domestic and foreign interest rates, so that this year monetary policy contributed to increasing the size of capital movements.

The foreign currency operations of the private sector are subject to a ramified system of controls. The purpose of foreign exchange controls is to restrict capital exports at times of balance of payments difficulties, and prevent speculative short-term capital imports when the domestic interest rate is higher than abroad. It is difficult to judge to what extent foreign exchange controls have succeeded in preventing capital movements, but the experience of 1987, as that of earlier years, shows that controls are not an effective barrier to capital movements of a size estimated at up to $500 million per quarter. Israel's experience in this regard is no different from that of other countries. In economies with extensive foreign trade, and the large financing flows associated with it, it is difficult for the authorities to prevent speculative capital movements with the control instruments at their disposal. Furthermore, it is necessary and desirable to permit capital movements which are needed for reasonable foreign trade operations.

Foreign exchange controls have side effects: they create distortions as they hamper businesses in the efficient conduct of their foreign operations. This damage is equal to an additional cost of credit from abroad and a diminishing of returns on holding assets abroad. Evidence to that effect can be found in the recorded responses to changes in the control regulations— a contraction in the volume of credit subject to administrative ceilings, or credit which became much more expensive, and compensating increases in the volume of relatively unrestricted categories of credit.

The impost on credit from abroad, at the low rate that was proposed, might have eliminated some of the distortions, had it been imposed equally on all types of foreign borrowing, because it would then have been possible to gradually lift the restrictions that discriminate between the different categories of credit. However, the approval eventually given for the surcharge applied only to a comparatively narrow credit segment, so that it lost its distinctive character as a non-discriminatory policy instrument.

These circumstances lead to a degradation of the statistical reports on private sector capital movements. The direct short-term capital imports of the nonbanking private sector, as reported in recent years, are not a reliable estimator of the amplitude of short-

Table VII–8
BALANCE OF PAYMENTS OF THE PRIVATE AND THE PUBLIC SECTOR, 1985–87[a]
($ million, current prices[b])

	1985	1986	1987	1986 I	1986 II	1987 I	1987 II
Public sector							
1. Goods and services account	1,284	1,590	686	325	1,266	–171	857
2. Medium and long-term capital movements	4	348	22	–24	372	–118	140
3. Basic account	1,288	1,938	707	301	1,637	–290	997
4. Short-term capital movements	–94	7	0	–3	10	–5	4
5. Capital movements of the banks on behalf of the public sector	159	116	–123	6	110	–196	73
6. Errors and omissions	117	–410	268	–158	–252	170	98
7. Effect of the public sector on the foreign reserves [increase (–)]	–1,471	–1,651	–852	–146	–1,506	320	–1,172
Private sector							
1. Goods and services account	–178	–769	–940	–316	–454	–239	–701
2. Medium and long-term capital movements	76	153	331	–100	253	221	110
3. Basic account	–103	–616	–609	–415	–201	–18	–591
4. Short term capital movements	–82	–139	108	–79	–60	62	46
5. Capital movements of the banks on behalf of the private sector	–163	–135	239	–118	–17	506	–267
6. Errors and omissions	–722	231	161	319	–88	288	–127
7. Effect of the private sector on the foreign reserves [increase (–)]	1,071	659	99	293	366	–838	938
8. Derived capital imports of the private sector –(3+7)[c]	–892	110	840	23	87	1,077	–237

[a] Definitions in this table have been changed this year. Foreign currency transactions between the private and the public sector are now included in three rows: row 7 for the private shows the public's foreign currency purchases from the Bank of Israel's foreign reserves. The current account, row 1 in both parts of the table, is adjusted for identified transactions between the two sectors, and therefore differs from the figure appearing in Table VII–2. Unidentified transactions are included in row 6, errors and omissions.

[b] Differences in totals are due to rounding

[c] Derivedcapital imports are defined as the difference between the private sector's purchases of foreign currency and its current account.

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

term speculative capital movements, and sometimes not even of their direction. The data on capital imports via the banking system are more reliable, but these are under tight control. This makes it necessary to use alternative indicators to estimate capital movements.

The derived capital imports of the private sector—defined as the difference between purchases of foreign currency from the Bank of Israel and the private sector's current account—is the sum total of the private sector's capital account transactions. The general indication provided by this figure is that capital outflows were checked in 1986, followed by large-scale capital inflows in early 1987, after the nominal devaluation in January. In the third quarter of the year these inflows tapered off, and in the last quarter there were sizeable capital exports.

An examination of the various components of private capital movements and indicators for capital movements that are not fully reported, clearly reveal the same pattern. Thus, for example, unilateral transfers to the private sector rose in the first half of the year, and declined in the second half. Private sector unilateral transfers are not included in the capital account, but their magnitude is determined by the same considerations which affect the capital account. Direct investment by foreigners also increased. These two modes of transfers are relatively free of controls. The change in the 'errors and omissions' item in the private sector's balance of payments is also consistent with this trend. This item includes the differences between the trade flows and reported capital movements, and the recorded change in the foreign reserves; it may therefore serve as an indicator of unreported capital movements.

The development of capital movements can also be examined by looking at the factors affecting them. Short-term private sector capital movements—in excess of the financing requirements of its current account deficit—are influenced by considerations of the worthwhileness of holding assets and taking up loans in local currency as against assets and credit in foreign currency. This depends on the relevant interest rates and the expected changes in the exchange rate between the date of taking up such credits and their due date. After the adoption of the stabilization program in mid-1985, the gap between domestic and foreign interest rates widened, and its variance declined (see Table VII–9)[10] Until early 1987 the public did not take advantage of this interest rate gap, through large capital imports. This indicates that there was uncertainty—lasting until mid-1986—as regards the continued stability of the exchange rate. Another indicator of uncertainty is provided by the premium on the black market dollar; when the stabilization program was introduced, this premium fell to some 8 percent, but a further decline came only in mid-1986. Since then, the black dollar premium changes have been consistent with the capital movements described above.

[10] The interest rate abroad is represented in Table VII–20 and Fig. VII–9 by the three-monthly rate; since no long-time series is available for domestic interest on time-loans, the local interest rate is that on overdraft facilities. The calculated differential is therefore upward-biased, but not its variance.

Table VII–9
CAPITAL IMPORTS BY THE PRIVATE SECTOR
AND INTEREST RATE DIFFERENTIALS, 1984–87

		$ million	*Percent*[a]			
		Derived capital imports[b]	Interest rate Domestic[c]	Interest rate Foreign[d]	Gap between domestic/foreign interest rates[e]	Black market premium on the dollar[f]
1984	II	–119	19.0	16.7	2.3	19.9
	III	–146	22.6	20.5	2.1	14.8
	IV	–152	22.4	17.9	4.4	9.1
1985	I	–247	16.1	11.2	4.9	19.2
	II	–289	19.1	14.5	4.5	27.0
	III	48	17.4	6.6	10.8	8.5
	IV	–404	9.0	1.0	8.0	7.9
1986	I	–43	4.9	0.6	4.3	7.8
	II	66	3.5	0.6	2.9	8.5
	III	35	3.6	0.3	3.3	4.0
	IV	53	3.8	0.4	3.4	1.0
1987	I	589	4.4	3.2	1.2	-1.0
	II	488	4.3	0.6	3.6	–0.3
	III	72	3.8	0.6	3.2	4.2
	IV	–308	3.7	–0.9	4.6	8.9
1988	I		3.5	1.0	2.5	5.8

[a] Differences in totals are due to rounding.
[b] The difference between purchases of foreign currency by the private sector and its current account.
[c] Effective rate of interest on overdraft facilities, monthly average.
[d] Eurodollar 3-month rate, monthly average.
[e] Difference between columns 2 and 3.
[f] Black market dollar rate relative to representative exchange rate.

SOURCE: Based on Central Bureau of Statistics data.

The Foreign Debt

After many years of rapidly rising net foreign debt (on average, by 16 percent a year between 1973 and 1984), it was reduced in 1985 and has since then remained stable at about $19.2 billion (see Table VII–10).

An analysis of the external debt poses two basic questions: first, to what degree the foreign debt deviates from the desired path; and second, how the debt is distributed between borrowing sectors, lending sectors and due dates. Both aspects have implications for the country's international credit standing: the first is mainly related to the evaluation of the basic economic state of the country, and the second, mainly to problems of liquidity, the ability to recycle the debts, and its cost.

Table VII–10
ASSETS AND LIABILITIES IN FOREIGN CURRENCY, 1983–87[a]
($ million)

	1983	1984	1985	1986	1987
1. Net liabilities (2–3–4)	18,270	19,686	19,253	19,156	19,224
2. Liabilities	22,825	23,670	23,952	25,025	26,332
Government	14,789	15,580	15,521	16,193	16,528
Nonbanking private sector	3,159	3,410	3,746	3,941	4,648
Banking system, net	4,877	4,680	4,685	4,891	5,156
3. Foreign reserves[b]	3,780	3,255	3,793	4,868	5,962
4. Exporters' credit to foreigners	774	728	906	1,001	1,146
5. Current liabilities	4,766	4,737	4,842	5,109	5,857
Banking system (short term)	2,444	2,388	2,301	2,224	2,378
Nonbanking private sector (short term)	1,021	960	1,048	1,233	1,459
Direct government debt (short term)	220	158	2	25	0
Medium and long term debt repayable within a year	1,081	1,231	1,491	1,627	2,020
6. Net current liabilities (5–3–4)	211	754	142	–760	-1,251
7. Net current debt as percent of net debt	1	4	1	–4	–7
8. Gross liabilities	29,847	30,394	30,354	31,605	32,779

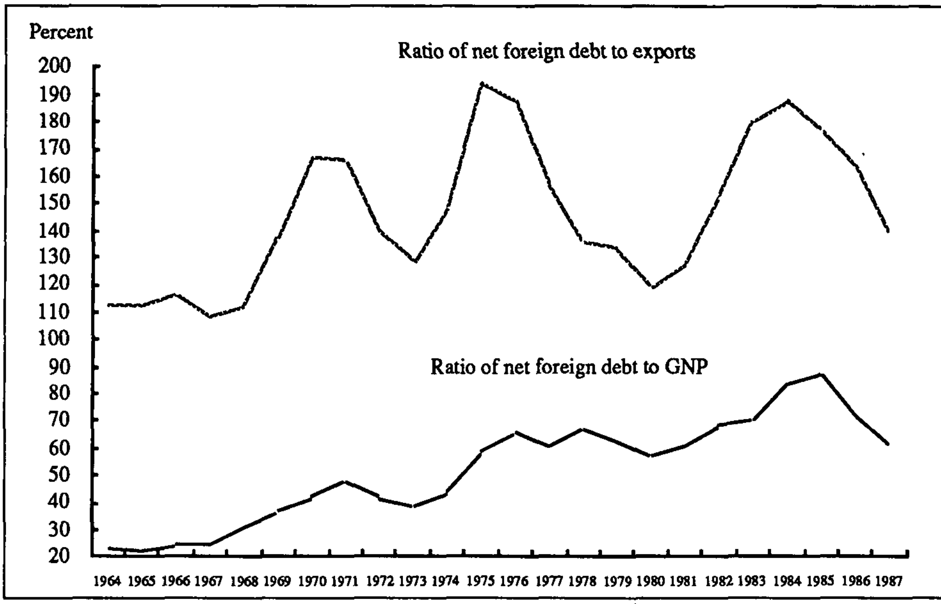
[a] Differences in totals are due to rounding.
[b] Held by central monetary institutions (see Appendix Table VII–A12).
SOURCE: Based on data of the Central Bureau of Statistics and the Bank of Israel.

The customary measure of the degree of the economy's deviation from the desired path is the ratio of the foreign debt to GNP, for reasons discussed in section 2 of this chapter. In the last three years the debt/GNP ratio improved considerably, declining from 80 percent in 1984 to 57 percent in 1987. The decline was made up of a 2 percent net reduction of the debt in dollar terms, a real increase of 8 percent in GNP, and a 23 percent rise in GNP prices translated into dollars. The ratio of the foreign debt to exports also showed a considerable amelioration: it declined from 188 percent in 1984 to 140 percent in 1987.

The structure of the net foreign debt according to several criteria is presented in Appendix Table VII–A12. No substantial changes can be seen to have occurred in 1987 in the comfortable features of the debt structure. The share of the public sector is still high—55 percent; the country has net assets invested in the international banking system, medium- and long-term debt is bigger than net debt, so that there is a surplus of liquid assets over current liabilities.

The gross foreign debt includes residents' foreign currency deposits of about $1 billion. This biases the gross debt upward, but not the net debt. International comparisons show that Israel's gross external debt is large by any measure, relative to both GNP and exports (world data available are only for gross debt). The debt is high also

Figure VII-4
RATIO OF FOREIGN DEBT TO GNP AND EXPORTS, 1964–87



DEFINITIONS: Debt – net, at current prices, end of year; exports – f.o.b., current dollar prices; GNP – according to the national accounts, in dollars at the official exchange rate.

SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

compared to countries unable to service their debt; their gross debt amounts on average to 48 percent of GNP. This comparison highlights that this particular structure of the country's debt is highly important for its international credit standing. A preliminary examination of the new loans taken up by Israelis in 1987 points to an improvement in the country's credit standing and a decline in the risk premium Israeli borrowers face abroad.

The indicators of the foreign debt burden show improvement in the last two years. Net interest payments to abroad were 4.6 percent of GNP; 3.2 percent of this was on government debt, and the remainder, about 1.5 percent of GNP, on private sector debt.