CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

THE STRONG UPSURGE in economic activity, which began in the middle of 1967, carried over through the year reviewed. Gross national product expanded by 13 percent at constant prices, employment rose steeply, and unemployment contracted sharply. These developments were accompanied by the continued relative stability of wages and prices. On the other hand, the import surplus grew appreciably and foreign currency reserves were heavily depleted.

The reflationary monetary and fiscal policies adopted at the end of 1966 began to leave their mark in several areas at the beginning of 1967, when the economy started to emerge from the slowdown of the two preceding years. The trend turned sharply upward in the middle of 1967, with the main thrust coming from the huge increase in Government spending and its deficit financing during and immediately after the Six Day War. Most of the incremental Government demand was directed to the home market, leading to a rapid recovery in industry, construction, and certain other sectors. With the growth of employment and incomes, the upswing in economic activity grew more widespread toward the end of 1967, and in the course of 1968 it encompassed all sectors. Outstanding gains were posted by industry, where output was up 30 percent, by transportation and communications, and by the construction sector.

During the year reviewed the influence of other factors, felt to only a limited extent in 1967, also grew stronger. In the wake of the general economic boom, investment by the private sector and public sector companies, which had contracted sharply during the recession, rapidly regained ground. Gross domestic capital formation expanded by 44 percent in 1968, thereby contributing to the continued vigorous growth of the economy. In addition, the export drive accelerated as a result of higher profitability, favorable conditions in foreign markets, and other factors. Total exports of goods and services, including those to the administered areas, were 26 percent larger at constant prices than in 1967. Export demand grew considerably, constituting about 30 percent of the total demand increment. These developments in the spheres of investment and exports were reflected by a rapid increase in employment and incomes; this in turn was followed by a steep rise in private consumption, which was thus added to the expansionary forces. Total private consumption spending at constant prices was up 12 percent, and per capita by 8 percent. The larger influx of new immigrants also contributed to the acceleration of economic activity.

The expansionary influence of the Government's operations was on a scale

Table I-1

MAIN ECONOMIC INDICATORS, 1965-68

(percentages)

	Increase or decrease (–) as against previous year				
	Average 1961–64	1965	1966	1967	1968
Resources and uses					
(at constant prices)					
Total domestic uses	11.6	6.0	–0.4	2.9	15.3
Gross national product	10.8	8.4	1.5	1.1	13.2
GNP per capita	6.5	4.8	–1.1	–2.0	9.5
Private consumption	10.8	8.2	3.1	1.4	11.9
Private consumption per capita	6.5	4.6	0.5	–1.7	8.2
Public consumption	10.6	10.5	8.3	36.0	7.5
Gross investment	14.5	–1.3	–14.8	–26.3	44.0
Foreign trade[a]—goods and services ($)					
Imports	14.3	3.0	4.0	10.6	25.8
Exports	16.0	14.0	16.0	6.6	20.7
Import surplus	13.3	–9.1	–14.5	18.4	34.7
Population and employment					
Average population	4.0	3.4	2.6	3.2	3.4
Number of employed	5.2	3.0	–0.6	–4.3	9.0
Number of unemployed (daily average)	–14.1[b]	–4.7	126.8	58.0	–56.3
Prices and national income					
(nominal)					
Average monthly wages per employee	12.6	17.5	19.1	0.4	3.2
Hourly wages	12.0	18.4	19.8	3.3	–0.3
GNP prices	7.6	9.6	8.0	0.7	2.6
Consumer price index (annual average)	7.3	7.7	8.0	1.6	2.1
National income	18.3	20.6	9.6	3.0	16.0
National income per capita	13.8	16.6	6.8	0.0	12.2
Finance					
Money supply (annual average)	19.8	9.0	7.3	20.3	19.0
Bank credit to the public (annual average)	20.5	10.0	19.0	36.0	28.7

[a] Excluding trade with the administered areas.
[b] Average for 1963 and 1964 only.

similar to the peak level reached in 1967. However, in contrast to 1967, when the much stronger expansionary effect of such operations occurred against a background of widespread unemployment and a decline in demand and private investment, in 1968 the sizable demand surplus and net credit outflow of the Government came on top of other stimulative forces at work in the economy.

The continued rapid economic expansion of 1968 was reflected by heavier demand in the labor market. Gainful employment was 9 percent over the 1967 level, and the number of hours worked per employed increased by some 4 percent. Employment expanded in most sectors of the economy, but the rise was especially striking in industry and construction, where it amounted to more than 15 percent. The result was a sharp drop in unemployment and in the number of persons working on relief projects. The number of workers from the administered areas increased during 1968. At the end of the year, the unemployment rate was still higher than before the slowdown, but a shortage of skilled labor was already felt in various branches. The downward trend in unemployment carried over into the early part of 1969, when it approximated the level of previous boom periods.

Despite the much stronger demand for labor, wages rose only slightly in 1968. This relative stability is explained by several factors: the existence of unemployment, the larger number of workers from the administered areas, the freezing of wage rates as part of Histadrut (General Federation of Labor) policy, and the nonpayment of a cost-of-living allowance increment because of the stable price level.

Prices actually began to stabilize in the middle of 1966. But whereas until the second half of 1967 the stability was due to sagging demand, it was subsequently maintained in the face of a marked upturn in demand and economic activity. The large reserve of idle factors of production (both labor and equipment), coupled with the stability of wages, made it possible to expand the supply of goods and services in line with the rapid growth of demand, without driving up production costs. Additional factors helping to maintain stability were the freezing of indirect tax rates and the raising of subsidies, the freezing of prices subject to Government control, the import liberalization policy, the increase in factor utilization, and the fact that much of the incremental demand was for imported products, so that it did not press on the level of domestic prices. Against the background of these stabilizing influences, the devaluation of November 1967 had only a slight impact on the domestic price level.

The rapid growth of the economy concurrently with price stability must be viewed in the light of the marked worsening in the country's balance of payments position during 1968. This deterioration was due entirely to the growing trade deficit, which soared from $ 198 million in 1967 to $ 392 million in the year reviewed, following the appreciable expansion of imports as a result of the intensification of economic activity. The deficit on services account shrank somewhat after rising steeply in 1967, mainly because of the larger import for security purposes. The total current deficit reached $ 696 million, as against $ 531 million in 1967 and $ 445 million in 1966.[1]

1 These data include trade with the administered areas. Excluding these areas, the trade deficit rose from $ 211 million in 1967 to $ 430 milion, while the total deficit on goods and services account went up from $ 445 million in 1966 to $ 527 million in 1967 and $ 710 million in 1968. The following discussion of imports and exports does not include trade with the administered areas.

The strong advance in economic activity in the year reviewed was reflected by an increase of 41 percent in commodity imports. The growth of imports, which began to accelerate in the last quarter of 1967, encompassed almost all categories, but was especially marked in items that had contracted sharply during the recession, such as industrial and construction equipment and durable consumer goods. There was also an appreciably larger import of raw materials for branches experiencing a vigorous growth of production. Another factor responsible for the rapid expansion of imported materials was the sharp rise of exports, the import component of which is relatively high. The import of raw materials was apparently intended in part to replenish stocks run down during the previous year.

Total proceeds from commodity exports were up 16 percent, while exports of locally produced goods rose by some 20 percent. The largest contribution to the advance was made by industrial products, which gained nearly 25 percent, whereas agricultural exports edged up only 3 percent. Several factors account for the exceptionally large increase in industrial exports in 1968. To begin with, the existence of surplus production capacity during the recessionary period, which prompted producers to turn to the overseas market, still made its influence felt in 1968. In addition, world trade picked up noticeably after sagging in 1967. Another factor giving a strong boost to exports was their much higher profitability in 1968. This was partly connected with the system of incentives introduced at the end of 1966, but the main cause was undoubtedly the larger return on exports after the devaluation in November 1967. The devaluation was particularly effective in stimulating overseas sales, since it involved virtually no increase in prices or wages. The relative stability of wages, together with the higher productivity in the industrial sector, further enhanced the competitiveness of Israel's goods.

It was the combination of these factors and the availability of a large reserve of idle factors of production in the early months of 1968 that explains the impressive expansion of industrial exports. But as the year wore on, the moderating effect of the buoyant domestic market conditions on industrial exports grew stronger, and in the latter part of 1968 and the beginning of 1969 the advance began to slow down.

There was also an increase of 28 percent in proceeds from service exports, with tourism and transportation leading the way.

Imports of services expanded by only 11 percent, after a steep rise of 39 percent in 1967 due to the larger security requirements.

Since the deficit on current account exceeded capital imports, Israel's foreign exchange reserves were heavily depleted, for the first time in many years. Net foreign currency balances fell by nearly $ 100 million in 1968, after expanding considerably the year before. In 1967 capital import reached a new high of some $ 820 million, owing to the huge flow of aid from world Jewry that year.

In 1968 the figure dropped to approximately $ 650 million, mainly because of the smaller proceeds from the emergency campaigns conducted abroad and from net sales of Development Bonds, which were exceptionally brisk in 1967.

The drain on foreign exchange reserves had a contractionary monetary effect. While the year was marked by rapid monetary expansion, it was slower than in 1967. The money supply expanded by 14 percent in the course of the year, compared with 26 percent in 1967. The rise in the annual average level was 19 percent in 1968, as against 20 percent the year before. Other financial assets of the public increased at the same rate in both years—by about 28 percent. The main sources of monetary expansion were the increase of some IL 970 million in the amount of credit provided to the Government by the banking system, and that of IL 590 million (29 percent) in bank credit to the public. The decrease in foreign currency assets and the open-market operations of the Bank of Israel absorbed part of the additional liquidity generated by the huge expansion of credit to the Government and the public.

In view of the rapid growth of the money supply, which occurred mainly in the early months of 1968 and threatened to undermine the stability of the economy, the Bank of Israel took countervailing measures from May onward. This represented a reversal of the reflationary policy pursued as long as there was large-scale unemployment of factors of production. The liquidity ratio on time deposits was raised progressively from 10 to 15 percent, while the obligatory liquidity ratio on incremental demand deposits was revised from 65 to 70 percent. Moreover, the Bank of Israel stepped up sales of the Government Short-Term Loan in order to mop up part of the excess liquidity.

As a result of these measures and the decline of foreign currency balances after a seasonal rise at the beginning of the year, the pace of monetary expansion began to slacken. Owing to the existence of sizable liquidity surpluses in banking institutions and the heavy lending to the Government in the second quarter of 1968, money began to get tight only during the last three months of the year. This was reflected by a rise in interest rates and by the renewed expansion of bill brokerage, which had been on the decline from the beginning of 1967.

Not all of the monetary expansion found expression in the growth of aggregate demand, since the demand for financial assets continued upward, thereby helping to ease demand in the commodity and service markets and to check the upward pressure on prices which might otherwise have resulted from the rapidly mounting liquidity of the economy.

Gross saving from disposable private income from all sources expanded by some IL 580 million, or 26 percent, compared with 25 percent in 1967. Part of the increase can be attributed to the much larger volume of unilateral transfers from abroad, as the propensity to save from such income is comparatively high. Gross saving from disposable private income from domestic sources alone totalled

IL 240 million; the rate of saving in this case remained at the 1967 level of about 19 percent, which is a little greater than in previous years. Data are not available for breaking down private saving into its two components, household and business saving, but it is reasonable to assume that the latter increased in 1968 in view of the larger business profits.

The dissaving of the public sector remained at its high 1967 level of some IL 1,500 million, which depressed the volume of national saving to a marked extent during the past two years. The huge public sector dissaving in 1967 was connected with the bulging security expenditure, which was not accompanied by an increase in tax revenue. In 1968 the public sector's revenue from taxes and other transfers went up by as much as IL 850 million approximately, owing primarily to the rapid expansion of economic activity and imports, but on the other hand transfers and subsidies to the public were some IL 320 million above the 1967 figure. The result was that, despite the much slower growth of public consumption, the sector's dissaving remained at its high 1967 level.

The vigorous economic expansion was sustained throughout 1968, and partial indicators show that it carried over into the early months of 1969. However, toward the end of 1968 there was some slackening of the growth rate in several sectors as compared with the end of 1967 and the first part of 1968.

When the economy first began to emerge from the recession, a number of special nonrecurrent factors—chiefly the precipitate rise in public consumption—drove up demand sharply in the short run. With the subsiding of their impact, there was some deceleration in the growth of the national product, though it continued upward at a relatively strong rate. The more sluggish growth of exports, and to a lesser extent of industrial production, which had expanded at an unprecedented rate during the previous period, stood out in particular. The rise of employment also slowed down in the second half of the year reviewed. On the other hand, investment and private consumption showed no signs of slackening. It should be added that with the increase in factor utilization in the latter part of 1968, the first constraints on rapid expansion from the supply side began to appear in a number of branches.

The continuation of stability, at a time when the reserve of idle factors is gradually disappearing, is conditional on keeping the growth of demand in line with the anticipated slower expansion of the economy's available factors of production. The central problem facing the economy is how to maintain relatively rapid economic growth and simultaneously step up exports so as to reduce the big balance of payments deficit on current account. The acceleration of overseas sales depends on the expansion of export production capacity by attracting capital and labor and enhancing the country's ability to compete in foreign markets. The continuation of the present import and export trends is liable to lead to a rapid depletion of the State's foreign exchange reserves, and hence detrimentally affect the future development of the economy.