

## CHAPTER VI

### ISRAEL AND THE WORLD ECONOMY

#### 1. MAIN DEVELOPMENTS

The deep recession in the industrialized countries reached a stage of definite recovery in 1976. For the year as a whole growth attained a rate of about 5 percent – still somewhat above the growth rate of potential output. But the recovery was concentrated in the first half of the year. A reversal of fiscal stimulus, as well as other less obvious factors, appear to underlie a pause in the recovery during the second half of the year. In the United States the growth of final demand showed a clear revival in the fourth quarter, and the output growth rate followed it in the first months of 1977.

Inflation continued to decelerate among industrialized countries, and, generally speaking, elsewhere as well. Although tropical commodity prices began to climb, good harvests in the principal grain areas (in the United States, the U.S.S.R. and elsewhere) prevented significant cost pressure in 1976.

By contrast, the Israeli economy, under the impact of such cost raising policies as devaluation and rising indirect taxation, while achieving a major cut in its current deficit, suffered an intensification of both recession (a widening gap between actual and potential GNP) and inflation.

World trade experienced its normal disproportionate response to the growth cycle, rising by more than 11 percent during 1976 after an extraordinary fall of about 5 percent in 1975 as a result of the world recession. Capital flows harmonized with this change. Industrialized countries fell back from a surplus into a current account deficit, thus reducing the deficit of the developing countries by about 10 billion dollars and increasing the surplus of the oil exporters by somewhat less. Adjustment to the post-1973 regime of terms of trade appeared to make headway. In particular, the developing countries did not (with individual exceptions) lose credit worthiness. The few major currency depreciations among industrial countries (e.g. U.K. and Italy) were primarily reflections of earlier exceptionally high rates of internal inflation. Fluctuations during the year in the most important exchange relationships (i.e. those of the dollar or the D.M. vis-a-vis other major currencies) were the smallest since the general abandonment of fixed rates.

The strong resurgence of Israeli export growth in 1976, while set in motion by the reversal of the world market decline, was prepared and stimulated by other factors, including real devaluation over several years, the introduction of new products, and the new agreement with the EEC, which substantially reduced tariffs on imports from Israel.

TABLE VI-1  
**GROWTH OF REAL GNP IN OECD COUNTRIES, 1963-76**  
 (percent change at annual rate)

	1963-1964 compared to 1973-1974	1975	1976	1975	1976		Last quarter for which there are data
				1st half	1st half	2nd half	
Canada	5.4	0.6	4.8	3.9	6.3	2.8	3.4 (III 1976)
U.S.A.	4.0	-1.3	6.2	7.9	6.5	3.8	5.2 (I 1977)
Japan	9.4	2.1	5.8	3.6	8.3	3.2	1.0 (III 1976)
France	5.4	-1.2	5.2	2.8	7.0	1.8	- (III 1976)
W. Germany	4.4	-3.2	5.6	4.7	7.1	3.8	7.6 (IV 1976)
Italy	4.7	-3.7	5.0	1.4	8.5	1.0	1.8 (III 1976)
U.K.	2.7	-1.8	1.1	-2.8	2.6	2.2	6.2 (III 1976)
Total above countries:							
Weighted by OECD	5.0	-1.3	5.5	5.1	6.7	3.3	
Weighted by Israel's exports <sup>a</sup> (1974)	4.5	-1.7	4.9	3.9	6.2	3.0	
Other OECD countries	5.0	-0.6	2.5	..	..	..	
Total OECD	5.0	-1.2	5.0	4.5	6.0	3.25	

<sup>a</sup> Weights according to 1974 exports.

SOURCE: 1963-1975 Organization for Economic Cooperation and Development, *Economic Outlook*, December, 1976; 1976 - IMF; 2nd half of year estimates are partially forecasts; quarterly figures, the Federal Reserve Bank of St. Louis, Second Quarterly Report.

## 2. CYCLICAL CHANGES IN 1976

Considered as a whole, 1976 was the first year of general recovery from the recession in the major countries which began in 1974. For the OECD area as a whole, real GNP rose by 5 percent after a fall of 1.2 percent in 1975. World trade rose in volume by about 11 percent after falling nearly 5 percent in 1975. For the U.S. and, to a lesser extent, the next two largest national economies, Japan and West Germany, this trend continued a recovery which began in the third quarter of 1975. For most of the other European countries it represented the first period of strong recovery (see Table VI-1).

In spite of the unambiguous character of the full year's change, the recovery of 1976 was flawed by a uniform slowdown (or "pause") after an equally uniform (and unmain- tainable) peak during the first quarter. During the second quarter more divergent move- ments became noticeable. The U.S., for example, continued a gradual deceleration in output growth through the rest of the year, but final demand revived in the last quarter as did output growth in the first quarter of 1977. Some others (e.g. the United Kingdom and Germany) moved back to an intermediate or even high growth rate during the third or fourth quarters. Some countries including France and the United Kingdom exhibited rather erratic fluctuations from quarter to quarter.

The remarkable harmony shown in the general slowdown testifies to the growing interdependence of national economies. For the U.S. the slowdown reflected (a) the exhaustion and partial reversal of the fiscal policy stimulus applied in 1975 and (b) the continuation of a low trend of monetary expansion in relation to the continuing, al- though dampening, pressure of price rises in the U.S. economy. Elements of the same causation were obviously present in many of the other countries, especially the reversal of the fiscal policy stimulus (see Table VI-2 on fiscal impacts).<sup>1</sup> Lessening U.S. trade de- mands played some part, and, despite an initial appearance of greater ease, monetary policy in Europe and Japan tended to be restrictive ( $M_1$  velocity was relatively static in most of these countries, while following a strongly declining trend in the U.S.)

**Prices:** High inflation has been an extraordinary feature of the post-1973 world recession. An understanding of the development of this inflation in 1976, as in previous years, is vital to an understanding of the real phenomena of the world economy.

On a year to year basis inflation tended to drop almost everywhere – but at unequal rates. The steeper declines appear to reflect either successful restraint of internal cost- push elements (especially, but not only, nominal wage increases), the lagging impact of severe demand restriction (and recession) in 1975, or a combination of both policies.

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<sup>1</sup> Table 2 shows two alternative measures of fiscal impact; OECD estimates of direct tax changes affecting household income, and IMF estimates of the overall fiscal balance impact on aggregate demand. Both show the same directions of impact for all countries except the United Kingdom.

Small declines (e.g. Italy, France or Sweden) by the same token, reflected less demand restraint, and, in the more extreme cases, the current or lagging consequences of a failure of "income policy" to curb a wage-price spiral.

TABLE VI-2  
**MEASURES OF FISCAL POLICY, 1974-76**  
 (Percent increase or (-) decrease compared to previous year)

	Influence of the changes in direct taxation on real disposable income of households			Changes in the influence of fiscal measures on GNP corrected for cyclicity	
	1974	1975	1976	1975	1976
Canada	-0.5	1.7	-1.2	2.5	0.0
U.S.A.	0.8	3.7	-0.9	3.0	-1.0
Japan	0.5	2.0	1.0	2.5	-0.5
France	0.1	1.1	-1.7	2.0	-1.5
W. Germany	0.1	4.9	-1.2	1.5	0.0
Italy	-1.0	2.9	-2.2	2.0	-3.5
U.K.	-0.4	-3.7	0.2	2.5	-2.5
The 7 industrial nations	0.4	2.7	-0.7		

SOURCE: Influence of changes in direct taxation – Organization for Economic Cooperation and Development, *Economic Outlook*. December, 1976. Changes in the influence of fiscal measures – estimates of the IMF.

Some countries (esp. the United Kingdom and Italy) experienced a frustrating impulse to further price inflation arising from sizable depreciations of their currencies. In the U.K. this seemed to offset much of the benefit of a severe new policy of wage restraint imposed during 1976. Yet the depreciations were, in effect, the delayed reflection in internationally traded goods of the relatively high internal inflation rates over a longer period (in the United Kingdom – especially of the wage 'explosion' of 1975).

The price of many raw materials and food commodities, in particular those exported by tropical developing countries, began to rise under the impact of the OECD recovery of 1976 (and also due to bad harvests affecting coffee and cocoa). This is reflected in a somewhat misleading rise in some popular commodity indexes (e.g. the *Economist* Food Index) which are "biased" toward the outputs of these regions. Thus the 40 percent rise in the *Economist* Food Index in 1976 rivals that of 1972 at the start of the last

great commodity price boom. However, while the earlier rise was reflected in a sympathetic (although much lower) acceleration of U.S. and other wholesale food price indexes, the 1976 rise was not. Abundant harvests of the main temperate-zone cereals (especially wheat and corn) kept wholesale food prices (in dollars) stable or even caused them to fall. IMF data summarize the changes (for raw materials and metals, as well as food):

Increase or (-) decrease compared to previous year (percentages)					
All primary commodities		Commodities exported by developing countries		Commodities exported by developed countries	
1975	1976	1975	1976	1975	1976
-17.6	12.1	-18.1	14.7	-15.7	1.7

Most non-petroleum commodity prices (in sharp contrast to industrial wages and prices) are flexible in both directions. They thus tend to swing well below their long-term trend in periods of cyclical recession (e.g. 1975) and to rise exceptionally quickly during periods of recovery.

This implies that, as the world recovery proceeds, commodity prices will tend to put temporary upward pressure on rates of inflation, which will diminish when recovery is complete. (In late 1976 and early 1977 the commodity price rise was accelerating and by the latter period beginning to influence, *inter alia*, U.S. wholesale price inflation.) This brings the danger of renewed demand restriction (intentional or “automatic”) which could abort full recovery. However, it is worth noting that some serious forecasts of commodity prices for 1977 (e.g. that of the IMF) are fairly optimistic.<sup>2</sup>

To sum up, the general trend of decline in world inflation from 1974 through 1976 was, in essence, the result of the exhaustion (and partial cyclical reversal) of the sharp cost-push impulses which had been transmitted through the world economy by the oil and the commodity price booms of 1973 and 1974.

For some industrial countries these impulses had been largely “internal” (e.g. the agricultural, oil and forestry price booms in the U.S., Canada and Scandinavia). For most of them they had been “external”, taking the form of deteriorating terms of trade. The widely differing performances of various countries reflected their uneven progress in “absorbing” the shifts of real income made necessary by these relative price changes, and this involved differences in both demand and effective “indexation” policies, which we shall consider further below.

<sup>2</sup> Proposals for international stockpiles to dampen commodity price fluctuations got little further than the talking and “agreement in principle” stage during 1976. There were also signs of an upward price bias in a number of commodities (rubber, wool and, possibly, coffee) induced by governmental or inter-governmental measures to reduce production or marketing from existing stockpiles.

**Israel:** Macro-economic trends in Israel, while bearing a broad relation to international developments, differed greatly from those described above. Briefly, real recovery was negligible (real GNP growth rising from 0.4 percent in 1975 to about 1.2 percent in 1976), as a steepening fall in real domestic demands (especially investment) offset about three quarters of the very substantial rise in exports. Secondly, the rate of price inflation, although falling on a year-to-year basis, rose steeply during the year under review, and ran at 4 or 5 times the OECD average, as opposed to its earlier trend of less than twice that average.<sup>3</sup> As in the previous two years, this reflected a continuation of the policy of pursuing a reduction in the current account deficit through devaluation, plus a demand restraint policy which relied heavily on a cost raising approach (e.g. indirect tax increases). This policy bore much more fruit in terms of its primary objective than in the previous year, primarily because of the sharp reversal of world trade.

TABLE VI-3  
GROWTH OF ISRAEL'S EXPORT MARKETS, 1973-76<sup>a</sup>  
(percent change at annual rates)

	1973	1974	1975	1976	1975	1976	
					2nd half <sup>b</sup>	1st half	2nd half
Weighted by total Israeli exports, incl. diamonds							
Developed countries	11.1	0.3	-8.8	14.1	12.01	18.21	11.80
Other countries	16.6	15.0	11.7	10.5			
Total	12.6	4.4	-2.5	13.0			
Weighted by total Israeli exports, excl. diamonds							
Developed countries	10.3	0.1	-8.3	13.6	12.10	18.10	1.04
Other countries	14.8	15.6	17.3	8.3			
Total	11.6	4.9	0.4	11.7			

a Based on import growth weighted by share of Israeli export, 1974 weights.

b Based on 9 out of the 15 developed countries.

SOURCE: Organization for Economic Cooperation and Development, *Economic Outlook*; IMF International Financial Statistics.

Israeli data: Central Bureau of Statistics.

<sup>3</sup> A discussion of this can be found in Chapter IV as well as in other chapters of the report.

**TABLE VI-4**  
**SUMMARY OF WORLD TRADE CHANGES, 1973-76**

	1973	1974	1975	1976
World trade volume <sup>a</sup>	13.0	5.0	4.5	11.0
<b>Import volume</b>				
Industrial countries	12.5	1.0	-7.5	14.5
Other developed countries	17.0	6.0	-7.5	3.5
Major oil exporters	21.5	39.0	42.0	16.5
Other developing countries	13.5	8.0	-5.0	2.0
<b>Export volume</b>				
Industrial countries	14.0	7.5	4.5	11.0
Other developed countries	3.0	1.0	-	12.0
Major oil exporters	13.5	-1.0	-11.5	12.0
Other developing countries	8.0	3.5	0.5	9.5

<sup>a</sup> Excluding the Soviet Bloc and China. Based on average growth rate of import and export.

SOURCE: International Monetary Fund data.

**TABLE VI-5**  
**RISE IN OECD CONSUMER PRICES, 1974-76**  
(percent change at annual rate)

	1974	1975	Year ending Oct. 1976	1976			
				I	II	III	IV
Canada	10.9	10.8	6.2	5.4	6.2	6.1	6.0
U.S.A.	11.0	9.1	5.3	5.2	4.9	5.5	4.5
Japan	24.4	11.7	8.6	9.6	13.1	4.5	10.6
France	13.7	11.7	9.9	10.0	9.5	9.5	10.6
West Germany	7.0	6.0	3.8	6.9	6.2	0.3	2.0
Italy	19.1	17.2	20.1	15.9	27.8	11.0	30.3
Netherlands	10.0	10.2	8.7	6.8	14.0	2.7	10.6
U.K.	16.0	24.1	14.7	12.2	14.7	12.3	17.1
<b>Total</b>	<b>13.2</b>	<b>10.4</b>	<b>8.1</b>	<b>8.1</b>	<b>6.3</b>	<b>7.4</b>	

SOURCE: 1974-1976 - OECD, *Economic Outlook*, December 1976.

Quarterly data - Federal Reserve Bank of St. Louis, "Main Economic Indicators."

However, the effect of the strong cost-push factors imposed (including a high effective degree of wage "linkage"). Plus a relatively low trend of growth in the money supply, produced both more inflation and more dampening of real domestic demand than had been anticipated.

**The Pursuit of Recovery and Price Stability in the Industrial Countries:** The development of the world economy has been dominated for the past several years by the efforts of national governments to restore desired targets in the fields of inflation, growth and balance of payments. As the Annual Report noted, this effort has been made more difficult since about 1973 by the sharply increased instability in world commodity prices; a result of both the elimination of 20 years of agricultural stockpiles in the U.S. and the new cartelistic militancy of raw material exporting countries, exemplified by OPEC. The difficulty may also be heightened by less obvious and slower trends, such as a tendency toward increasingly rigid wage linkage, union militance, and greater harmonization of world business cycles as the result of growing trade and capital market interdependence.

In this section we briefly explore the effect of the relative priority given by various governments to the "winding down" of the inflation peak imposed by the commodity and OPEC "cost-push" of 1974, and to the avoidance of real output loss. For this purpose Figure VI-2 presents a modified "Phillip's curve" in which the growth of the GNP gap<sup>4</sup> from 1973 to 1975 is plotted against the relative disinflation achieved by 1976 (i.e., the 1976 GNP price change as a proportion of that in 1974).

Although the detailed results in Figure VI-1 are subject to a "random" element, they are good enough to show that, despite the range of policies followed regarding wages, taxes, and other cost elements, there still was a statistically significant degree of "trade-off" between growth and disinflation. Extreme disinflation — as in Switzerland — usually went together with a severe loss of output. Conversely, the most successful maintenance of full employment output and growth (Sweden in the diagram) was in fact achieved where little progress was made toward controlling inflation.

Nevertheless, the existence of this correlation is less important than the wide range of deviations from the norm (which would be still wider in a diagram showing the average output and price performance for 2 or 3 years, or including additional countries).

Some of the deviations shown may not be too significant (in particular, Japan's may reflect our simple extrapolation of its very high pre-1973 growth rate); but most will, on closer study, reveal important differences in (1) the success of "incomes policy" (especially wage policy), and (2) in other factors affecting costs (e.g. the use of indirect taxes). In the United Kingdom and Italy in particular, and to a lesser extent in France, wage restraint was relatively weak.<sup>5</sup>

<sup>4</sup> Approximated by extrapolation of the trend growth rate from 1962 to 1972.

<sup>5</sup> As noted earlier, in the U. K. wage restraint strengthened during 1976, but this was too late to restore a normal relationship in the diagram, primarily because of the lagging impact of the earlier 1975 wage explosion on the exchange rate and import costs in 1976.

TABLE VI-6  
**CHANGES IN WAGES, PRODUCT PRICES AND EXPORT PRICES  
 IN SEVEN MAJOR OECD COUNTRIES, 1975 AND 1976**  
 (percent)

	1975				1976			
	Hourly wage	GNP prices	Export price index		Hourly wage	GNP prices	Export price index <sup>a</sup>	
			Local currency	SDR			Local currency	SDR
Canada	15.8	10.8	10.0	5.9	12.5	9.5	2.8	11.1
U.S.A.	9.1	9.3	11.8	10.7	7.5	5.1	3.5	8.4
Japan	11.5	7.1	1.3	-1.1	11.0	7.2	-2.7	2.0
France	17.3	13.9	5.5	17.0	15.5	9.0	8.8	2.2
West Germany	8.25	8.1	7.3	11.9	6.0	3.1	1.7	4.1
Italy <sup>b</sup>	26.7	17.5	13.1	11.7	21.5	16.6	18.9	-2.1
U.K. <sup>b</sup>	26.3	27.9	23.0	15.4	15.5	15.3	19.6	1.8
All industrial countries		10.9	8.9	10.9		7.1	5.5	4.6
Total OECD	13.6				10.75			

<sup>a</sup> Unit values. It should be noted that changes in exchange rates tended more or less to offset (both in SDR and in local currency) drastic changes in export prices in local currency, especially in 1976.

<sup>b</sup> Product prices tended to drop as a result of the slowing of wage increases, although consumer prices (Table VI-5) rose rapidly as a result of the devaluations.

SOURCE: Product and export prices – IMF; Wages – OECD, *Economic Outlook*, December 1976.

TABLE VI-7  
**GROWTH OF MONEY SUPPLY (M<sub>1</sub>) IN SELECTED COUNTRIES, 1975 AND 1976**  
 (percent, quarterly changes<sup>a</sup>, seasonally adjusted, at annual rates)

	1975				IV 1975 compared to IV 1974	1976				IV 1975 compared to last quarter with data
	I	II	III	IV		I	II	III	IV	
U.S.A.	0.6	7.6	7.3	2.3	4.4	2.9	8.5	4.3	6.4	5.5
W. Germany	11.7	16.6	16.8	20.9	16.5	5.8	6.2	7.5		6.5
France	5.9	2.6	25.3	19.9	13.1	22.8	7.3	9.8		13.1
U.K.	8.8	32.8	24.9	10.9	19.0	15.2	9.7	22.4		15.7
Italy	14.3	-7.9	25.1	14.9	10.9	39.8	17.5			28.2
Japan	11.2	8.9	15.9	7.9	10.9	24.3	9.6	14.6	11.0	14.7
Netherlands	14.2	31.1	30.1	8.4	20.5	21.1	3.3	-13.2		2.8
Belgium	10.4	16.5	15.5	13.2	13.9	8.7	12.2	8.7		9.9
Switzerland	7.1	5.0	-1.3	4.9	3.9	16.3.	5.5	4.3		8.6

<sup>a</sup> Average quarterly changes of monthly data.

SOURCE: Federal Reserve Bank of St. Louis.

TABLE VI-8  
WORLD CURRENT ACCOUNT, 1975 AND 1976  
(\$ billion)

	Excl. official transfers			Incl. official transfers		
			Increase or (-) decrease from previous year			Increase or (-) decrease from previous year
	1975	1976		1975	1976	
OECD	6.5	-10	-16.5	-6.5	-22.5	-16
OPEC	36	44	8	34.5	42	7.5
Nonoil developing countries	-41	-33	8	-32.5	-24	2.5
Other countries <sup>a</sup>	-14.5	-13.5	1	-14	-12.5	1.5
Total <sup>b</sup>	-13	-12.5	0.5	-18	-17	1.0

<sup>a</sup> Sino-Soviet area, South Africa, Israel, Cyprus, Malta, and Yugoslavia.

<sup>b</sup> Theoretically the world current account should total zero. In practice this does not happen, due both to the unreliability of the reports from several countries and the time lapses in recording imports and exports.

SOURCE: OECD, *Economic Outlook*, December 1976, Table 24.

On the other hand, the more favorable position achieved by countries like Denmark, Belgium, Austria and Canada (and to a lesser extent of Germany and the U.S.), appears to reflect either greater success in the implementation of an incomes policy (reducing cost-of-living linkages and control of real wages) or simply, more flexible wages due to the absence of formal linkage and weaker unionization.<sup>6</sup>

Israel's unfavorable rightward deviation from the trend in Figure VI-2 (both a high loss of GNP and little disinflation) still understates the extremity of its position over a longer period. If we related the 1976 price change to the average of the precycle decade (1962-72) rather than to the 1974 "peak", Israel would appear much further to the right relative to the other countries shown. On average, the latter had brought their inflation down by 1976 to about one and one half times its longer term rate. Israel's was still four times that rate.

<sup>6</sup> Switzerland's favorable deviation (an extraordinary degree of disinflation even at the high price paid in real GNP) was probably more influenced by a discontinuity of cost-push pressures in the face of a really severe recession (i.e. a collapse of these pressures in 1976 after a stubborn lag over several years).

TABLE VI-9  
TERMS OF TRADE IN SELECTED COUNTRIES, 1974-76  
(percent)

	1974	1975	1976	Export unit value in SDR		Import unit value in SDR	
				1975	1976	1975	1976
U.S.A.	-13.9	2.5	0.2	10.7	8.4	8.0	8.1
Japan	-20.4	-8.3	-3.9	-1.1	2.0	7.3	6.2
France	-14.1	7.5	-0.7	17.0	2.2	8.8	2.6
West Germany	-8.3	7.3	-1.4	11.9	4.1	4.2	5.7
Italy	-17.9	6.3	-5.4	11.7	-2.1	4.7	3.5
U.K.	-14.9	9.9	0.5	15.4	1.8	5.0	1.2
All European countries	-10.6	5.8	-1.2	13.4	3.3	7.2	4.4
All industrial countries	-11.1	2.9	-0.9	10.9	4.6	7.7	5.6
Other developed countries	-10.6	-8.5	—				
Major oil exporters	138.9	- 5.1	5.1				
Other developing countries	-7.4	-11.5	5.6				
Israel	-18.0	-2.2	3.1				

SOURCE: IMF data: Israel — Table VI-10 below and various reports.

This difference, however, exemplifies the fact that, besides wage linkage, various other cost-push factors may affect a particular country's position. Indeed, Israel experienced more of these than did the other countries: specifically, a deliberate drive for "real" devaluation, indirect tax increases and a high degree of "effective" linkage<sup>7</sup> of wages to consumer prices. The last two factors imply that the target of "real" devaluation (a relative rise in export and import prices) would require a high rate of nominal devaluation.

<sup>7</sup> Including both the formal linkage of 70 percent and the largely successful pressure for additional increases to offset the remaining 30 percent of the inflation. Although real devaluation was an indispensable component of Israel's endeavor to reduce its current account deficit, the other cost-push elements (indirect taxes, high wage linkage and thus, the necessary rate of nominal devaluation) might, in principle, have been replaced or restrained.

FIGURE VI-1  
GNP CHANGES IN SEVEN MAJOR  
COUNTRIES, 1969-1975

(percent, compared to same half  
of previous year, annual rates)

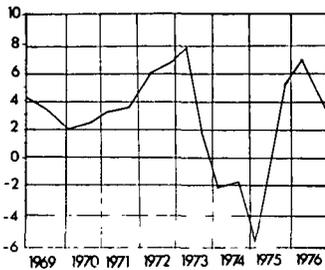
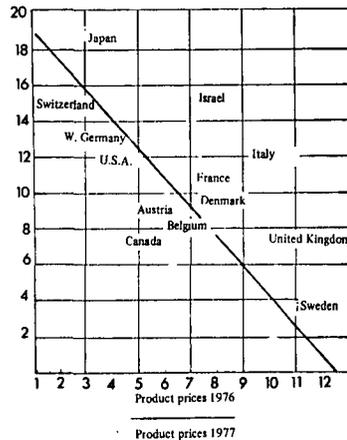


FIGURE VI.2  
POTENTIAL GNP PLOTTED AGAINST  
CONTROL OF INFLATION, 1969-1976

Difference between  
potential and actual GNP  
as percent of potential GNP



### 3. INCOME AND DEMAND POLICY IN 1976

The analysis above allows us to examine individual country policies with a wider perspective. Broadly speaking, a widespread view has developed stressing the need for stronger demand reflation in economies with the least inflation and relatively "strong" currencies, especially the U.S., Germany and Japan, while condoning or even urging restrictive demand policies in countries where inflation is high and the currency is weaker. In several major countries of the latter description (the United Kingdom, Italy and France), in which growth was already below normal rates in the second half of 1976 (see Table VI-1), policies tended to be formulated along these lines. But in view of the fact that slightly faster growth in the favored countries would have a quite limited impact on the exports and output of the others, and that inflation can be restrained considerably by improved incomes policies (fortunately also included in the policies of the countries noted above), the stress on restrictive demand policies seems somewhat inconsistent with the primary objective: world economic recovery.<sup>8</sup>

<sup>8</sup> The quite possibly disproportionate social or political consequences of pressing further deflationary demand policies upon countries already beset by high unemployment and related problems, should also be considered.

TABLE VI-10  
ISRAEL'S TERMS OF TRADE IMPACTS, QUARTERLY, 1975 AND 1976  
(1973 average = 100<sup>a</sup>)

	1975				1976				1975	1976
	I	II	III	IV	I	II	III	IV		
1. Index of import prices <sup>b</sup>	159.0	158.5	149.5	145.5	147.3	150.1	151.4	155.8	153.1	151.1
2. Index of export prices <sup>b</sup>	125.9	123.9	121.3	121.2	126.2	121.7	123.2	129.6	123.1	125.2
3. Terms of trade index (1)-(2)	79.2	78.2	81.1	83.3	85.7	81.1	81.4	83.2	80.4	82.9
4. Percent change in (3) from 1973	-20.8	-21.8	-18.9	-16.7	-14.3	-18.9	-18.6	-16.8	-19.6	-17.1
5. Terms of trade "import effect" <sup>c</sup> as a percent of:										
Domestic uses	-8.5	-8.9	-7.7	-6.8	-5.8	-7.7	-7.6	-6.8	-8.0	-7.0
GNP	-11.5	-12.1	-10.5	-9.3	-7.8	-10.5	-10.4	-9.4	-10.9	-9.5
6. Terms of trade effect on national income (percent of GNP <sup>d</sup> )	-4.6	-4.8	-4.2	-3.7	-3.1	-4.2	-4.1	-3.7	-4.3	-3.8
7. Change in (6) from 1975										0.54

a Figures in previous reports were based on the first quarter of 1973. Average terms of trade for 1973 were about 5 percent lower than those for the first quarter of 1973.

b Laspeyres index.

c Equals the necessary decline in imports (as compared to 1973) if a similar decline in purchasing power of capital imports and import earnings took place (in other words, if nominal capital imports change at the same rate as export prices).

d Computed as the change in the terms of trade (line 4) times exports, expressed as a percent of GNP (based on 1974 data). This constitutes the approximate effect of the terms of trade changes on real national income (percent change from 1973). For example, the figures show that 3.8 percent must be deducted from the constant price change in GNP from 1973 to 1976, in order to obtain the simultaneous change in Israel's real national income.

#### 4. GROWTH AND INFLATION ELSEWHERE IN 1976

The performance of the developing countries and the rest of the non-OECD world (the communist countries) should also be noted in this discussion, if only in the briefest way. Generally, developments were favorable, particularly in South and East Asia. There the average rate of real growth was about 6 percent (well above 1975), while price inflation, already quite low in 1975 – an average 8.2 percent – virtually ceased (1.9 percent). Good harvests, in India and elsewhere, played a major role in this outcome, but credit should also be given to a degree of sophistication in policy seldom associated with “underdeveloped” economies. An example was provided by South Korea, which achieved a rise from its already high growth rate of 8.5 percent in 1975 to approximately 15 percent in 1976, while halving its rate of inflation from approximately 24 to 12 percent.<sup>9</sup>

Elsewhere, average growth rates recovered from 2 percent in 1975 to over 4 percent in Latin America and Africa, and maintained a rate of about 5.5 percent among our neighboring non-oil states in the Middle East. Price inflation was kept at about 18 percent in Africa and fell from 20 percent to about 16 percent in the Middle East. Only in Latin America did inflation rise, and there the rise was concentrated in politically disturbed countries (especially Argentina and Chile). Apart from these the average rate was 27 percent. Poorer harvests in Eastern Europe (plus lagging effects of higher raw material prices charged by the U.S.S.R.) slowed growth slightly in 1976 (but not below an average of about 5 percent). A much needed improvement in grain harvests achieved the opposite result for the U.S.S.R. However, U.S.S.R. growth rates – measured in “net material product” – were still relatively low: rising from 2.3 percent in 1975 to 3.7 percent in 1976.

#### 5. TRADE, CAPITAL MOVEMENTS AND EXCHANGE RATES

Despite its hesitant character, the recovery of 1976 produced a dramatic turnabout in world trade. Disproportionate cyclical movements of trade are in fact the rule, and the exceptionally strong fluctuation this time reflects the greater weight of inventory changes in this cycle.

Of course, both the developing raw material producers and OPEC benefited from this recovery – which implied a fall in the “LDC” (Less Developed Countries) trade deficit, a rise in OPEC’s surplus, and a corresponding shift to deficits for the industrialized group (see Table VI-8).

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<sup>9</sup> The performance of South Korea throughout the world cycle since 1973 is worth closer study. The opening of a much larger current account deficit in 1974 (due to the familiar terms of trade and export market losses) was met with increased capital imports and devaluation. The growth rate (which had resembled Israel’s 10 percent trend up to 1973) fell only slightly, then rose steeply (in 1976), while a strong export orientation worked to control and even cut the import surplus.

TABLE VI-11  
**WEIGHTED AVERAGE CHANGES IN VALUE OF \$ AND IL FROM  
 SMITHSONIAN PARITIES, 1976 AND JANUARY 1977<sup>a</sup>**  
 (percent)

	Change in IL exchange rate <sup>b</sup>				Change in \$ exchange rate <sup>e</sup>
	Weighted by imports <sup>c</sup>		Weighted by exports <sup>c</sup>		
	Due to change in \$	Total <sup>d</sup>	Due to change in \$	Total <sup>d</sup>	
1976					
January	-2.1	-43.1	-6.5	-45.7	-5.2
February	-1.9	-43.8	-6.8	-46.6	-5.5
March	-0.3	-43.9	-5.9	-47.0	-4.3
April	0.4	-44.4	-5.7	-47.8	-4.0
May	1.0	-45.2	-5.5	-48.7	-3.0
June	1.6	-45.6	-5.0	-49.2	-3.4
July	1.4	-47.0	-5.1	-50.4	-4.1
August	0.9	-47.8	-5.6	-51.2	-5.1
September	0.7	-48.5	-6.1	-52.0	-6.1
October	0.6	-49.8	-6.5	-53.3	-5.4
November	0.4	-50.9	-7.2	-54.6	-5.4
December	0.4	-51.5	-7.2	-55.1	-7.0
1977					
January	0.9	-52.1	-7.1	-56.3	

<sup>a</sup> These series represent the cumulative changes (since December 1971) in the amount of foreign currency obtainable per IL, rather than the change in the IL price of foreign currency (the conventional concept of the rate of exchange in Israel).

<sup>b</sup> Monthly average.

<sup>c</sup> 1972 weights.

<sup>d</sup> Includes the effect of the official devaluation of the IL.

<sup>e</sup> Reuter's index, based on weight of dollar trade; end-of-month position.

We have already noted the fact that the recovery in world markets brought a fairly strong price rise of commodities exported by developing countries (although the overall price pressure of commodities was held down by declining prices of major temperate zone

TABLE VI-12  
**DEVALUATION, INFLATION, AND THE HYPOTHETICAL  
 IL-FOREIGN "INTEREST DIFFERENTIAL"<sup>a</sup>**  
 (percent)

<i>i<sub>I</sub></i> (inflation rate)	<i>d</i> (annual rate of devaluation)		
	12	22	26
12	-3.1	-13.6	-17.8
25	9.1	-1.4	-5.6
30	13.8	3.3	0.9
38	13.9	10.8	6.6

NOTE: These computations do not cover the entire array of possibilities available to economic units. For example, Natad gains in excess of inflationary gains are taxable; the interest rates in IL are sometimes such as to discourage borrowing for speculative purposes.

<sup>a</sup> The hypothetical "interest" (or rate of return) differential shown in the table are computed as follows:

$$g \text{ (IL interest differential)} = (1 + r_I)(1 + i_I) - (1 + r_F)(1 + d) \times 100$$

where: *i<sub>I</sub>* = inflation rate in Israel x 0.9 (to reflect the lowering of linkage on bonds to 90 percent in 1976).

*r<sub>I</sub>* = formal interest in Israel (assuming a 4 percent interest rate on IL linked bonds).

*r<sub>F</sub>* = formal interest rate abroad (assuming a Eurodollar deposit rate of 7 percent).

*d* = rate of devaluation per year IL/\$. For example, 26 percent = 12 devaluations of 2 percent each.

food products). This development resulted, as one would expect, in a moderate terms of trade loss for the OECD group as a whole. (See Tables VI-9 and VI-10).

As in 1975, Israel's terms of trade appear to have lagged behind those of the OECD by one year, showing a rise in 1976 of between 3.1 and 4.7 percent.<sup>10</sup>

The tendency for Israel's terms of trade to lag appears to result mainly from the use of longer term contracts for many "commodity" type imports. Prices in this sector held more steady in 1976 here than in Europe, offsetting a stronger rise in Israel's industrial import prices and a weaker trend (actually a fall) in its industrial export prices (which may have reflected Israel's real devaluation). However, without the strong rise in diamond terms of trade, the overall figure would hardly have changed.

<sup>10</sup> In 1975 Israel's terms of trade continued to fall slightly, while those of the OECD reversed a significant fraction of the drastic 1974 loss. The range of 1976 improvements shown reflect respectively the Laspeyres indices of Table VI-12 and the Paasche indices shown in the terms of trade table of Chapter IV.

Whatever its precise sources, the 1976 change in Israel's terms of trade implied an increase in real national income of between 0.5 and 0.8 percent. This added a considerable fraction to the (small) rise in real income (1.3 percent) made possible by real GNP growth, providing slightly more leeway for wage or domestic demand rises consistent with reductions of the import surplus.

Capital movements and exchange rates tended to develop consistently with the cyclical and price trends noted earlier. The most disturbing incidents in the OECD area were the rather sharp depreciations of the lira and the English pound. As noted, these depreciations were a reflection in the exchange markets of the higher internal inflations of these countries, albeit with a lag induced by official intervention. Nevertheless, they set off the danger of demand repression severe enough to threaten the overall recovery process in Europe. The slow recovery and the environment of high unemployment (still growing slightly here and there), also set off the "classic" tendencies toward rising trade barriers, another signal of the importance of early recovery.

The most important change in capital flows was complementary to the partial reallocation of the OPEC induced trade deficit, from the developing countries to the OECD area. However, the implications of these movements require some interpretation.

It has been widely assumed, on the basis of the impression made by trade or current balance figures, that the great bulk of the deficit imposed upon the rest of the world by the surplus of OPEC since 1974 had fallen upon the LDCs. A recent IMF study, however, argues that the expansion of the nominal dollar deficits of this group has in fact been only slightly greater than might have been expected from the 'scale' effect of their real growth and of average world trade price rises (i.e. excluding changes in terms of trade). In the main, the OPEC surplus has been balanced by a large reduction in the surplus of the industrialized countries ( $\approx$  the OECD group). From an accounting standpoint the OPEC surplus has replaced that of the OECD as the "source" of capital exports to the LDCs.

One may not, however, conclude from these accounting relations, that the propensity to save in the OECD area has dropped by anything like the drop in its net capital export – or that, in effect, previous savings had simply been converted into consumption payments for more expensive oil. It would be equally consistent with the new current balances for the addition to world savings arising from the OPEC surplus to have been mainly added to capital formation in the industrialized area.

However, so far, the occurrence of recession in the industrial countries implies that, for cyclical reasons, this additional capital investment did not in fact take place. The potential increase was simply offset by the sharp cyclical reduction of domestic real income, savings and investment.<sup>11</sup> The net effect (and regional allocation) of the new

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<sup>11</sup> It is worth recalling that, quite apart from this capital export, the OPEC countries have been (successfully) increasing world capital formation by investing at least a comparable portion of their oil profits at home.

savings supply under conditions of full cyclical recovery, and the revival of capital formation in the OECD, remain to be seen.

A more serious threat than that of insolvency in the developing countries is inherent in the renewed uptrend in world dependence on OPEC oil. Increases in the output of alternatives (oil and other fuels) have been slower than hoped or expected, and U.S. dependence in particular has increased significantly. Although the OPEC price front split in 1976, probably for political more than economic reasons,<sup>12</sup> the Saudis delayed their threatened expansion in output.<sup>13</sup>

In the U.S. political pressures continued to prevent removal of production-inhibiting price ceilings.<sup>14</sup> The OPEC surplus available for investment abroad remained very large (over \$ 40 billion) and, although concentrated in the hands of a few "conservative" Arab monarchies, this implied a growing financial influence throughout the industrialized world.

## 6. ISRAEL - EXCHANGE RATES, TRADE AND CAPITAL FLOWS

No attempt will be made here to measure fully the effects of domestic and international factors upon Israeli trade and capital flows, but certain general points seem appropriate.

During 1976 the continuation of the creeping IL devaluation, together with an accelerated rate of inflation (especially a rise in the Cost-of-Living Index) and an increase in nominal IL interest rates, resulted in a steady and sharp reduction of the strong speculative pressure against the IL, which had developed during the previous year. This tended to improve the overall balance of payments in several ways: through cessation and possibly a reversal of the negative shift of "leads and lags" in trade;<sup>15</sup> reduced loss of receipts, in particular tourist receipts, to the black market (a large item); and, with a lag, the reversal of the declining trend of long-term private capital imports (particularly personal remittances).

However, working against the improvements induced by declining speculation, the increasing GNP "gap" and, thus, the increasing underutilization of the existing capital stock tended to reduce long-term private capital imports. This negative feedback effect of recession must be taken into account in future planning.

Various calculations indicate that real devaluation (a relative rise in export and import prices) did continue in 1976, although at a lower pace than in 1975, and that a con-

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<sup>12</sup> Although a genuine fear of retarding or reversing the industrial world recovery played some part.

<sup>13</sup> There were indications of this change at the beginning of 1977.

<sup>14</sup> This is even true of the energy program launched by the U.S. administration in April 1977, which would raise consumer oil prices sharply (through taxes), but leave producer prices largely unchanged.

<sup>15</sup> Unfortunately we only have indirect indicators of this important factor.

siderable part of the reduction in the import surplus can be credited to the cumulative effects of this factor. An additional large portion was due to more or less one-time factors, such as the continued fall in domestic "uses" and, possibly, part of the leads and lags effect and the penetration of new markets (especially in the defense sector). In addition, we should note the application of the new trade pact with the EEC, implying a sharp reduction in the remaining tariffs on our exports to Europe. The long-term significance of this change dwarfs its contribution to export expansion in 1976, though the latter may not have been negligible either.<sup>16</sup>

In 1977 it should be possible to continue to combine moderate real devaluation with a rate of return differential preventing negative speculative pressure, although the reduction of price linkage on bonds to 80 percent definitely makes this more difficult.<sup>17</sup>

The degree of nominal devaluation and, thus, of inflation required to reach this target depends crucially upon the domestic cost factors (including indirect taxes and nominal wages). Indeed, the major threat to the balance of payments at present is also the major threat to the direct reduction of inflation — namely the pressures and the expectations aroused by a lack of consistent nominal wage restraint.<sup>18</sup>

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<sup>16</sup> The agreement provided for the reduction of most EEC tariffs on industrial imports from Israel by 80 percent in 1976.

<sup>17</sup> Table VI-13 illustrates the effect of various combinations of rates of devaluation and internal inflation upon the differential rate of return to Israel currency over foreign currency assets (assuming 90 percent linkage, as in 1976). An expected negative differential would stimulate a "speculative" worsening of both the current and capital accounts.

<sup>18</sup> This factor clearly underlies a significant revival of negative speculation during March and April of 1977 (again directly reflected in a reversal of the low agio reached by the black market and "Nataf" market).