CHAPTER VII

THE BALANCE OF PAYMENTS

1. MAIN DEVELOPMENTS

The financing of the balance of payments continued to benefit in 1986 from favorable conditions. Although there was a renewed expansion of the civilian import surplus, the unilateral transfers received and the contraction of defense imports made it possible to maintain a large surplus on current account. These developments had a share in creating an atmosphere of confidence and continued to check private capital exports. The favorable state of the current account, however, is partly due to transitory factors.

In 1986 the civilian import surplus was some $700 million higher than in 1985, while direct defense imports decreased by the same amount, the level of unilateral transfers remained at the high level of the preceding year, and private transfers increased by about $350 million. Together with the increase in the civilian import surplus there was a real appreciation of the currency.

Civilian imports, excluding capital service, expanded 14 percent in volume. The composition of imports was marked by a large increase in the share of production inputs and consumer goods; imports of capital goods showed a slight decline, reflecting a contraction in the first half of 1986 and a subsequent recovery in the second half of the year, which continued into early 1987. Exports increased 4 percent in volume, with a 5 percent rise in industrial exports and a decline of tourism. The civilian import surplus expanded during 1986, as imports rose rapidly while exports advanced only moderately.

The net foreign debt was reduced by some $300 million, and its composition was improved. In the previous year the government had redeemed its short-term debts; in 1986 it moderately increased its foreign long-term borrowing. The private sector, in contrast, tended to switch from exporting capital to capital imports, as confidence rose and the substitution increased between local-currency credit and loans raised abroad, and in view of the considerable gap between the interest rates on these two types of credit (see the section on the capital account in this chapter). The foreign currency reserves increased by about $1 billion.

Table VII–1
BALANCE-OF-PAYMENTS INDICATORS, 1980–86

	1980	1981	1982	1983	1984	1985	1986
$ million							
Exports, excl. capital services	9,059	9,260	8,792	8,901	9,629	10,195	11,188
Civilian imports, excl. capital services	10,139	10,498	10,896	11,634	11,209	10,575	12,341
Import surplus							
Total	3,720	4,250	4,571	4,860	4,816	3,944	3,966
Civilian	2,028	2,044	3,053	3,818	3,354	2,116	2,818
Civilian, excl. capital services	1,080	1,239	2,104	2,734	1,580	379	1,153
Imports of capital services, net	948	805	950	1,084	1,774	1,737	1,665
Direct defense imports	1,693	2,205	1,517	1,043	1,462	1,828	1,148
Unilateral transfers, public sector	1,797	1,725	1,512	1,872	2,537	4,240	4,187
Unilateral transfers, private sector	1,186	1,200	1,104	983	815	803	1,149
Current account deficit (–) or surplus (+)	–737	–1,324	–1,954	–2,006	–1,464	1,098	1,370
Net medium- and long-term capital movements	1,397	1,268	1,133	2,349	1,276	–35	303
Basic deficit (–) or surplus (+)[a]	660	–56	–821	343	–188	1,063	1,673
Implied private capital imports[b]		54	883	480	–588	–1,053	–201
Net foreign debt	11,640	13,373	15,641	18,270	19,686	19,315	18,998
Net current foreign debt[c]	–1,657	–1,393	–1,223	163	746	192	–1,074
Foreign reserves, end-of-year[d]	3,526	3,814	4,317	3,780	3,255	3,793	4,868
Index, 1980 = 100							
World trade (quantity)	100	101	99	102	110	114	119
Terms of trade, civilian imports and exports, excl. capital services	100	102	108	111	107	107	110
Terms of trade, merchandise excl. diamonds	100	100	102	104	103	106	112
Relative prices[e]							
Imports	100	96	91	85	85	93	83
Exports	100	98	93	91	90	92	82

[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.

* * *

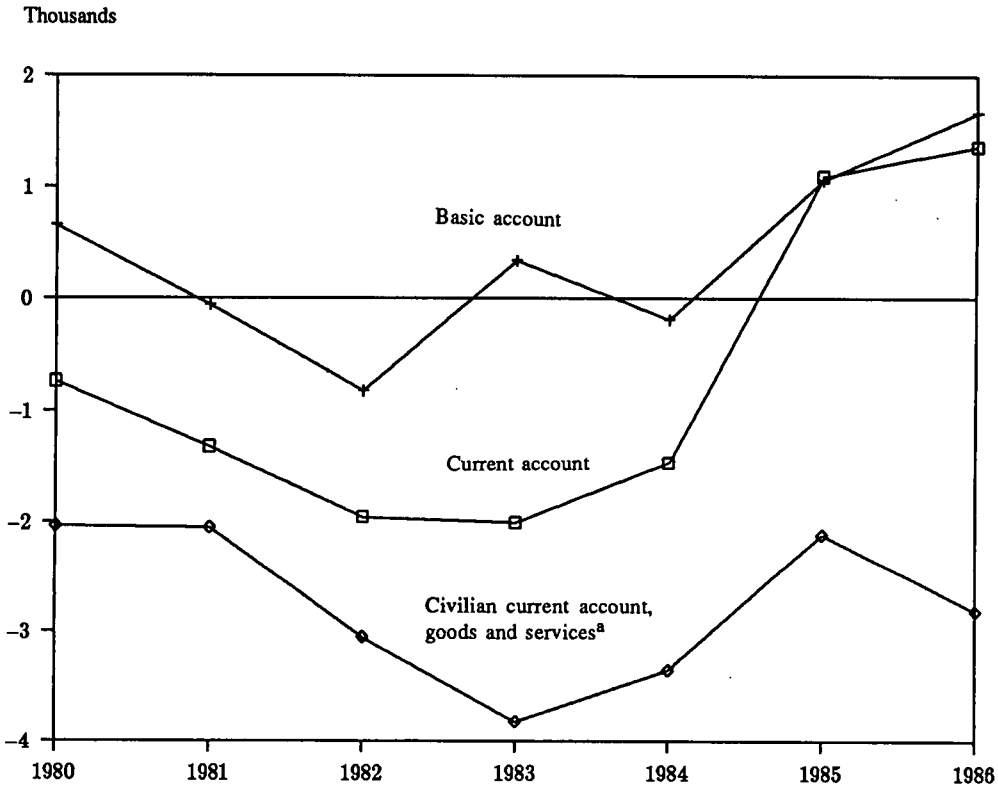
In recent years the economy's balance of payments position fluctuated widely—largely as a result of shifts in economic policy. Between 1980 and 1983 the civilian import surplus rose rapidly, with an ensuing deterioration in the current account and the basic account[1] and a mounting increase of the foreign debt. This course of events generated apprehensions among the public that financial assets might be taxed and currency controls be tightened, and these fears in turn engendered sizable private capital exports. In 1984 and 1985 these trends reversed themselves : the import surplus shrank, U.S. grants increased substantially, the increase in the foreign debt was halted, and private capital exports decelerated after the adoption of the stabilization program.

Fiscal restraint became stricter in 1986—a policy which tends to curb domestic demand and thus reduce the import surplus (the difference between domestic uses and GNP), and to lead to a real depreciation of the currency. Other factors, however, offset the restrictive effects of fiscal policy, among them—the increasing share of wages in national income and the rising tendency, in view of expected yields, to invest in stocks of production inputs and to purchase consumer durables. In consequence, domestic uses expanded by 8 percent in real terms, following two years of contraction. The increase in domestic uses expressed itself primarily in a higher import surplus, while GDP growth slowed slightly and the level of unemployment was somewhat higher than in the previous year (during the year, however, economic activity picked up). Early in the year, GDP and employment reacted only sluggishly to the expansion of domestic demand. This may be attributable to a combination of supply-side difficulties, including the wage increase and problems in the adjustment of the production system and exports to the changes in the composition of demand and relative prices, at home and abroad (see also Chapter II, and the section on the current account in the present chapter).

Both the price structure of Israel's foreign trade and the relative prices of locally produced tradables as compared with nontradables underwent extensive changes in 1986. The changes in the price structure of foreign trade (and local substitutes) were due mainly to two principal international developments: the fall in oil prices, and the appreciation of the European currencies and the yen against the U.S. dollar. Prices in the areas of the different currencies did not change in parallel with these changes in the cross rates, so that the prices of goods and services determined primarily in the markets

[1] This chapter uses the following definitions: Civilian import surplus = total import surplus less direct defense imports, and similarly for civilian import s; the current account = total unilateral transfers less import surplus; the basic account = the current account, plus medium- and long-term capital imports.

Figure VII–1
THE CIVILIAN IMPORT SURPLUS, CURRENT ACCOUNT AND BASIC ACCOUNT, 1980–86
(US$ billion)



[a] Equals civilian import surplus

SOURCE: Table VII–1.

of Europe and Japan rose more than prices determined in the U.S. and other dollar markets. In Israel, the change in international prices reflected itself in a relatively high price rise (in dollar terms) of imported final goods, lower fuel import prices, and a moderate price increase of other imported inputs and export goods. In addition, exports encountered difficulties in certain branches, and were possibly also affected by the slowing growth of international trade in manufactured goods (although Western countries increased their imports of industrial goods in 1986 at the same rate as in 1985, and total international trade also grew more rapidly).

Israel's total foreign trade displayed a 3 percent improvement in the terms of trade (the ratio of export to import prices)—equivalent to a gain of $300 million, or one percent of GNP.

International price developments can be said to have contributed to the increase of the import surplus: first, by providing an incentive for speculative imports of inputs; second, through the income effect of the improvement in the terms of trade; and third, through the lag in the adjustment of production to the change in prices. Since this lag was not perceived as permanent, it had a lesser impact on domestic demand than on GDP.

In addition to the changes in prices of tradables, there was in 1986 also a real appreciation: the price of tradables (exports, imports and their local substitutes) declined relative to that of nontradables. There is a clear relationship between the forces which in 1986 pushed for an appreciation and those that determined domestic demand and its allocation between imports and domestic production. An expansion of domestic demand in excess of GDP growth tends to raise the price of nontradables relative to tradables,[2] regardless of whether it comes from higher demand or from supply-side constraints. The connection between these two can be seen by comparing the top part of Figure VII–2 with its bottom part. This process was at work also in 1986 (although part of the incremental demand was from the outset directed to imports which have no close domestic substitutes), but it does not fully explain the real appreciation in 1986, particularly in the first half of the year. Other developments, primarily affecting nontradables, played a role in this connection: the effect of the rise in real wages on the services with their high labor-intensity; the rise in the average rate of taxation of nontradables, the increase in the prices of public services; and climatic and other natural causes of supply difficulties in agriculture (see also Chapters II and VI). Moreover, even when the rise in production costs affected tradables and nontradables similarly, producers of the latter, being protected against international competition, were better placed to raise their prices to match the increase in production costs, and to avoid the fall in profitability suffered by some of the export branches.

The process of real appreciation itself may have given rise to expectations of corrective action, thus leading to a speculative increase in the demand for imports. However, developments in the money and capital markets do not indicate that there were significant expectations of devaluation during 1986 (see Chapter VIII).

Disinflation policy held the nominal exchange rate of the sheqel nearly fixed from July 1985 to August 1986. As the U.S. dollar weakened, this policy led to a cumulative depreciation of the sheqel by 11 percent (of which about half occurred in the first seven months of 1986) against the 5-currency basket.

[2] The process is as follows: An overall rise in aggregate demand directs itself to both tradables and nontradables. An expansion of the supply of nontradables requires shifting additional factors of production to this sector, and this generally implies a rise in their relative prices. The demand for tradables, which grows because aggregate demand increases and because their relative price declines, is supplied by a higher import surplus, while the local production of tradables tends to shrink.

In August 1986 the exchange rate was pegged to the 5-currency basket and remained fixed until January 1987. In view of the expectations prevailing in early 1986 this policy seems to have had an influence on the wage rise, and thereby—on the real appreciation and the increase in the import surplus. It can therefore be said that the devaluation of January 1987 and its accompanying measures may contribute to an acceleration of growth and a contraction of the import surplus provided they release the economy from the trap of excessively high real wages and problems of price adjustment during the process of checking inflation. As for the future, it is appropriate to recall that nominal devaluations carry considerable risks of renewing inflation; such devaluations should be resorted to only when there are conditions for a real devaluation which cannot be realized because of nominal rigidities (see the section on the current account).

THE CURRENT ACCOUNT, ADJUSTED FOR ADVANCES ON IMPORTS OF DEFENSE GOODS, 1981–86

	1981	1982	1983	1984	1985	1986
1. Current account, goods and services, net	–4,249	–4,570	–4,861	–4,816	–3,945	–3,966
1a. Adjusted for defense goods advances	–3,839	–4,591	–4,973	–5,063	–3,999	–4,670
2. Total current account	–1,324	–1,954	–2,006	–1,464	1,098	1,370
2a. Adjusted for defense goods advances	–914	–1,975	–2,118	–1,711	1,044	666

Annual changes in the import surplus and current account are determined to a large extent by the wide fluctuations in the dates of supply of direct defense imports, while the flow of payments for these imports fluctuates much less. These payments include advances (positive or negative) for future supplies, which may be regarded as payments for goods in process of production. It is therefore useful to examine the import surplus and current account when the data are adjusted to include these advance payments.

In 1986 actual defense imports were $700 million less than the payments for the defense imports; when the data are corrected for advance payments, the import surplus is seen to have risen more, and the current account surplus to have been smaller than appears from the unadjusted data.

In the year under review the improvement of the current account was largely due to several transitory factors—primarily, the U.S. emergency grant-in-aid of $750 million as well as budgetary factors that may turn out to be temporary; nor is it likely that oil prices will remain at their low 1986 level. An additional factor in the improvement of

Table VII–2
THE BALANCE OF PAYMENTS, 1981–86[a]
($ million, current prices)

	1981	1982	1983	1984	1985	1986
1. Net goods and services account	–4,249	–4,570	–4,861	–4,816	–3,945	–3,966
Private sector	–1,634	–2,499	–3,051	–2,257	–821	–1,607
Public sector[b]	–2,615	–2,071	–1,810	–2,559	–3,124	–2,359
2. Net unilateral transfers[c]	2,925	2,616	2,855	3,352	5,043	5,336
Private sector	1,200	1,104	983	815	803	1,149
Public sector	1,725	1,512	1,872	2,537	4,240	4,187
3. Net current account (1+2)	–1,324	–1,954	–2,006	–1,464	1,098	1,370
Private sector	–434	–1,395	–2,068	–1,442	–18	–458
Public sector	–890	–559	62	–22	1,116	1,828
4. Net medium- and long-term capital[d]	1,268	1,133	2,349	1,276	–35	303
Private sector	–55	–120	1,068	173	–41	–40
Public sector	1,323	1,253	1,281	1,103	5	342
5. Net basic balance of payments (3+4)	–56	–821	343	–188	1,063	1,673
Private sector	–489	–1,515	–1,000	–1,269	–59	–498
Public sector	433	694	1,343	1,081	1,121	2,170
6. Net short-term capital movements	451	332	–416	505	–267	–702
Nonbanking private sector	52	280	64	79	–119	20
Public sector	399	52	–480	426	–148	–723
7. Capital movements of the banking system	762	1,660	252	–107	–4	–77
8. Errors and omissions	–580	–251	–745	–719	–391	98
9. Increase (–) or decrease (+) in foreign reserves[e]	–577	–918	565	509	–400	–992

[a] Figures may not add owing 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) and communication services, plus a component of imports of inputs financed by the government.

[c] See Table VII–7 for details.

[d] See Tables VII–10 and VII–11. Net capital movements of the private sector are the sum of row 3b in Table VII–10 and row 7 in Table VII–11.

[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.

the current account was the relatively low level of fixed investment in 1986, but this seems to be incompatible with the renewal of sustained growth.[3]

On the other side of the balance, a number of temporary factors operated in 1986 to increase the import surplus: large stocks of imported goods were accumulated, and imports of consumer durables were also exceptionally high. In addition, many internal and external factors hampered GDP growth, although their transitory character caused them to have only a slight effect on domestic demand, and thus to increase the import surplus.

It is difficult to quantify these varied factors; it seems, however, that the economy will find it difficult to revert to accelerated growth based on a bigger share of investment in GDP, without going through a transition period in which both the current account deficit and the foreign debt will increase again—unless there will be substantial changes in the levels of private consumption, defense expenditures, or unilateral transfers.

In earlier years the current account deficit was financed mainly by medium- and long-term loans, while short-term borrowing covered only a small part of it. This had the result that the basic balance-of-payments position was more favorable than the current account (see Figure VII–1). Since 1985 the U.S. has been giving its entire aid as outright grants rather than loans. This substantially reduced the proportion of medium- and long-term loans in the financing of the current account deficit, and narrowed the difference between the basic and the current account.

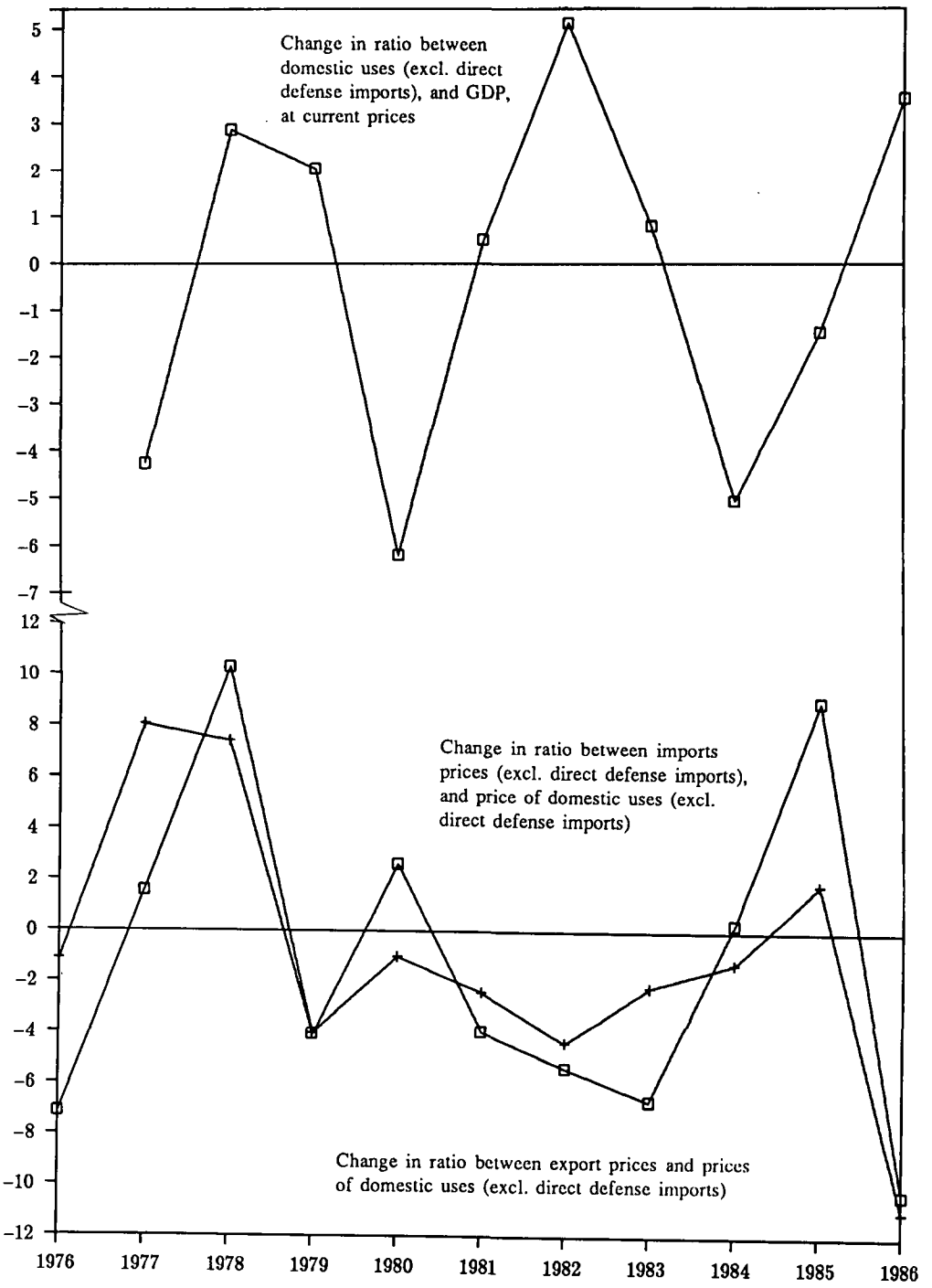
Changes in the balance-of-payments are considerably influenced by the public's decisions as regards the composition of its assets and liabilities, and particularly by decisions on the holding of tradable tangible assets (such as stocks of imported goods) and foreign securities, as against nontradable physical assets and domestic financial instruments (see also Chapter VIII). These decisions depend on the expected returns on the various types of assets, and the risk involved in holding them. Thus, in 1983 expectations of a rise in the relative price of foreign currency led to a surge in the acquisition of consumer durables, whereas in 1984 and early 1985 apprehensions of imposition of taxes on domestic financial assets and of stricter currency controls caused the private sector to accumulate net claims on the rest of the world.

The stabilization program calmed these apprehensions and raised the expected yields on local financial assets (and the cost of credit from domestic sources) relative to the yields expected on foreign-currency assets (or the cost of borrowing abroad). This

[3] This evaluation takes into account both the necessary increase in the capital stock and the restructuring of its composition required by the changes in the structure of relative prices, the slow-down of inflation, and similar factors. It ought to be observed in this connection that higher investment as such does not guarantee accelerated growth, which depends on various economic reforms to ensure an efficient use of the factors of production available to the economy.

Figure VII–2

DOMESTIC USES, GDP, AND RELATIVE PRICES, 1976–86



Note: The changeover to the new system of national accounts has only a negligible effect on the ratios presented in this diagram; therefore, no graphs are presented for the old and the new SNA.

occurred against a background of lower expectations of devaluation, high real interest rates on domestic credit, and uncertainty as regards the exchange rate of the dollar against the European currencies. As a result, private capital exports decreased in the second half of 1985 (see below, the capital account), and remained at a low level throughout 1986. Moreover, it seems that the rise in private unilateral transfers in 1986 was at least partly a reflection of decisions to increase capital imports. The private capital inflow rose considerably in early 1987, indicating that for the time being the public perceives the January 1987 devaluation as a one-time measure. The massive inflow of capital during this period made it apparent that it is difficult to maintain a substantial gap between local and foreign interest rates when economic tranquillity prevails and the exchange rate is stable.

Most of the current account surplus accumulated this year by public sector went to increase the foreign currency reserves, which in 1986 rose to $4.9 billion, as compared with $3.3 billion in 1984 and $4.3 billion in 1982. The net current debt,[4] which is a further indicator of the country's liquidity, decreased in 1986, and current assets exceeded current liabilities by about $1 billion.

The economy pays a price for increasing the foreign reserves, since the interest obtained on them is lower than that payable on part of the medium- and long-term debt. The optimal level of foreign reserves is difficult to determine, but it depends, among other things, on the anticipated flow of payments and receipts of foreign currency, on the government's credibility at home and abroad, and on the exchange rate regime. In the last two years the current account ran a surplus and there was growing confidence in the government. This tends to reduce the required level of foreign reserves. The transition to a regime of a fixed exchange rate, on the other hand, may imply a rise in the desired level of foreign reserves in order to dampen pressures for changing the exchange rate in response to the private sector's demand for foreign currency.

To conclude: The current account surplus of 1986 stemmed partly from a combination of favorable, but temporary, circumstances. In such conditions there is some danger that it may not be possible to raise the financing for the investments needed to renew economic growth without an interim period of several years in which the foreign debt will grow again. The increase of the foreign debt has been checked in the last two years, but it still stands at 70 percent of GNP, with interest payments on the debt amounting to 6 percent of GNP. In such circumstances there is a natural reluctance to restart a rise in the foreign debt, but it is equally important to escape from sustained economic stagnation.

The revival of economic growth no doubt requires accepting some risks as regards the balance of payments as well as price stability (one justification for which is its

[4] Defined as short-term debt plus medium- and long-term loans due for repayment within one year, less current assets held abroad.

potential contribution to the renewal of growth). Conspicuous among the risks that must be taken is that attached to the liberalization of currency controls in general, and on capital movements in particular. Such an easing of controls diminishes the Bank of Israel's command over the interest rate system and increases the economy's exposure to speculative capital movements, thereby making it more difficult to stabilize the nominal exchange rate which plays a central role in the disinflation policy. Nonetheless, resources for investment which are not available from domestic saving might become available to the economy by relaxing the controls on capital movements. Perhaps even more importantly, the lifting of currency controls compels producers and investors to adapt their economic decisions to the real cost of capital confronting the economy[5] (as long as individual producers and investors are properly made to bear these costs). Finally, the easing of currency controls also reduces the damage involved in evading the controls.

Experience with liberalizing currency controls in the world teaches that it is generally desirable to begin with relaxing the controls of foreign trade and the local financial system, and afterwards proceed to lift controls on capital movements. In the area of foreign trade a substantial measure of liberalization has already been achieved in the last 20 years; the trade agreements with the European Economic Community and the U.S.A. are likely to reinforce this trend. It may be added that under a regime of a fixed exchange rate the liberalization of foreign trade is of particular help in maintaining price stability. In contrast, the relaxation of controls as regards the local capital market is still taking its first steps; caution is therefore indicated in proceeding with the liberalization of international capital flows.

Exposing the economy to external capital movements is in a certain sense similar to its exposure to international trade: it requires preparatory local adjustments (in this case, primarily in the local capital market), increases external risks and neutralizes domestic risks, reduces the intervention of the authorities in managing the economy, and, last but not least, augments the potential rise of efficiency and growth.

[5] The international cost of capital to the economy is higher than that faced by the private borrower, since an increase in the foreign debt may affect the economy's risk exposure as perceived by lenders abroad, and therefore also the interest rate demanded from other domestic borrowers.

Another problem arises when expectations of domestic inflation are higher than those prevailing abroad: when the exchange rate is fixed, this may in the short run lead to a negative real interest rate on foreign borrowing. If such expectations prevail only in the short run, it is questionable whether they will cause a significant rise in real domestic demand, but they may induce relatively large capital movements. In certain conditions, such pressure may impose an adjustment of monetary expansion, and a more flexible levy on capital imports.

2. THE CURRENT ACCOUNT

In 1986 the balance of payments current account to some extent continued the trends of late 1985: for the second year running, a current account surplus (of some $1.4 billion) was recorded even though the civilian import surplus increased by $700 million.

The current account deficit is the difference between total national expenditure and the income available to the economy—the gross national product and unilateral transfers from abroad. An improvement in the current account can therefore come from a contraction of domestic demand, from an increase in the GNP, and from higher unilateral transfers. These three variables are interdependent; particularly important is the interrelation between the different demand components and the income available to the economy.

Figure VII–3 illustrates the changes in the major components of domestic demand, and shows that, as a percentage of GNP, there has been a continuous increase in the excess of private consumption over unilateral transfers from abroad to the private sector. In contrast, the surplus of public consumption (including net interest payments to the rest of the world) over unilateral transfer from abroad to the public sector shows a declining trend, particularly in the last two years. Gross investment in 1986 was up from the falling trend that predominated since the 1970s, but most of the increase was confined to investment in stocks. As will be seen below, the changes in domestic demand also represented a shift in the composition of imports by final uses.

Sustained improvement of the current account depends largely on the performance of the public sector, namely, its outlays as compared with its unilateral transfers from abroad. If private consumption (after deduction of unilateral transfers from abroad to individuals) continues to rise, only accelerated GNP growth can reduce its negative effect on the current account (under full employment). However, a sustained increase of the growth rate requires that investment take up a higher share of GNP, and this implies a deterioration in the current account in the short run. This effect may be offset by a reduction of the excess of public expenditure over public sector receipts of unilateral transfers from abroad.

It cannot be ruled out that the higher public sector receipts of unilateral transfers from abroad also had an effect on the increase in private consumption in the last two years. In deciding on their level of consumption, individuals base themselves both on their current and their future income (i.e., perceived permanent income). It has therefore been suggested that private consumption is affected also by the future tax burden, and thus by the present deficit in the government budget. An increase of public sector receipts from unilateral transfers, as well as a reduction of public expenditure, reduce the government's overall deficit. This arouses expectations that the future tax burden

will be lighter and their future disposable income will be bigger. Such expectations lead to higher private consumption already in the present. In other words: a balance of payments improvement stemming from a reduction of the net foreign debt (private and public) may influence private consumption, but it should be stressed that a temporary improvement, such as that resulting from non-recurrent grants, has a lesser effect on permanent income, and hence on private consumption, than a lasting improvement.

* * *

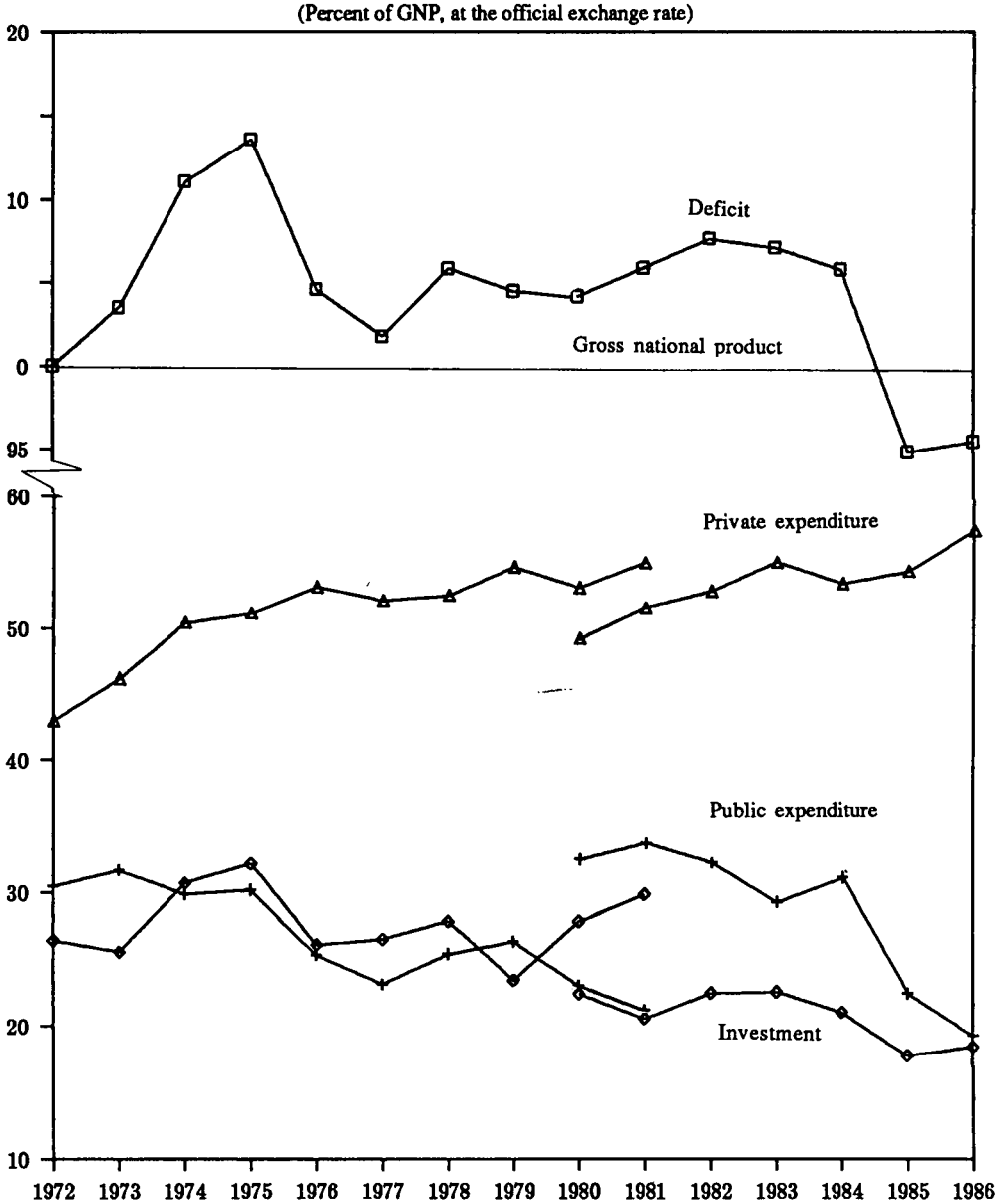
The year 1986 saw the consolidation of the stabilization program introduced in July 1985. One keystone of the program was the pegging of the exchange rate to the dollar, and economic developments since then should be examined against this background. The third quarter of 1985 recorded a substantial contraction of aggregate demand, and with it—rising unemployment and a decline in GNP. This contraction made it possible to continue reducing the civilian import surplus (see Table VII–3), but in the last quarter of 1985 imports increased while exports picked up. The trends of end-1985 continued in the year under review, and the civilian import surplus[6] increased by some $700 million, reflecting the expansion of domestic demand. A considerable part of the additional demand went to import goods that have no close domestic substitutes. Moreover, the composition of demand changed while the local production system had difficulty in adjusting quickly to these changes. In the course of the year, imports increased rapidly and exports showed a modest rise (according to not seasonally adjusted data, at current prices).

On average for the year, not all the components of imports went up; in merchandise imports, there was a conspicuous rise in imports of consumer goods (of 39 percent)—far in excess of the increase in private consumption—and of inputs for production (fuel—13 percent, diamonds—21 percent, and other inputs—19 percent). A considerable proportion of these imports seems to have gone into an accumulation of stocks which more than made up for their depletion in the second half of 1985. This may indicate the effect of lower interest rates and expectations of a recovery in economic activity in 1987. In imports of services, excluding capital services, a quantitative

[6] The civilian import surplus, which sank to its lowest level after the introduction of the stabilization program, rose back to $2.8 billion a year. This, although higher than in early 1986, is still lower than the level between 1982 and 1984. The ratio of the import surplus to GNP during the 1980s was as follows:

	1980	1981	1982	1983	1984	1985	1986	1986 I–VII	1986 VII–XII
Import surplus as percent of GNP, at official exchange rate	9.8	9.3	13.2	14.9	13.9	9.7	10.6	10.0	11.1

Figure VII–3
TOTAL NATIONAL EXPENDITURE BY COMPONENTS AND THE CURRENT ACCOUNT DEFICIT, 1972–86
(Percent of GNP, at the official exchange rate)



NOTES: The current account deficit is calculated at the official exchange rate. Private expenditure = private consumption, less unilateral transfers from abroad to the private sector. Public expenditure = total public consumption, less unilateral transfers from abroad to the public sector. 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 used from 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 of the Central Bureau of Statistics.

Table VII–5

GOODS AND SERVICES ACCOUNT, 1983–86[a]

	$ million				Percent annual change					
					Price			Quantity		
	1983	1984	1985	1986	1984	1985	1986	1984	1985	1986
Imports										
Goods, excl. fuel and diamonds[b]	5,705	5,298	4,971	6,375	–0.2	–1.9	9.0	–6.9	–4.4	17.7
Fuel	1,607	1,593	1,510	924	0.5	–6.2	–46.0	–1.4	1.1	13.3
Diamonds	782	880	1,168	1,598	–1.7	1.5	10.0	14.4	30.8	24.3
Services, excl. capital services[b]	2,803	2,830	2,397	2,666	–3.3	0.9	15.0	4.4	–16.0	–3.3
From Judea-Samaria and Gaza District	737	608	528	778	–5.5	1.6	16.9	–12.7	–14.4	25.9
Subtotal, civilian imports excl. capital services	**11,634**	**11,209**	**10,575**	**12,341**	–1.3	–1.4	2.9	–2.3	–4.3	13.5
Capital services	2,669	2,966	2,776	2,591						
Direct defense imports	1,043	1,462	1,828	1,148						
Total	**15,346**	**15,637**	**15,179**	**16,080**						
Exports										
Goods, excl. diamonds[b]	3,822	4,531	4,739	5,193	–0.9	–0.2	2.8	19.7	4.9	6.6
Diamonds	1,001	1,035	1,263	1,665	–4.9	–3.9	4.4	8.8	26.9	26.2
Services, excl. capital services[b]	3,217	3,308	3,454	3,393	–9.0	–0.8	8.5	13.0	5.2	–9.5
To Judea-Samaria and Gaza District	861	755	739	937	–4.8	–8.2	13.9	–7.9	6.7	11.2
Subtotal	**8,901**	**9,629**	**10,195**	**11,188**	–4.6	–1.5	5.6	13.4	7.5	3.9
Capital services	1,584	1,192	1,039	926						
Total	**10,485**	**10,821**	**11,235**	**12,114**						
Import surplus[b]										
Goods, excl. fuel and diamonds	1,882	767	232	1,182						
Current surplus of diamonds	218	156	95	67						
Services, excl. capital services[b]	413	478	1,057	727						
Civilian, excl. capital services	2,734	1,580	379	1,153						
Net capital imports	1,084	1,774	1,737	1,665						
Total, civilian import surplus	3,818	3,354	2,116	2,818						
Total import surplus	**4,860**	**4,816**	**3,944**	**3,966**						
Trade deficit	3,271	2,204	1,647	2,040						

[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.

Table VII–4
RELATIVE WHOLESALE PRICES, ISRAEL AND TRADING PARTNERS, 1983–87 I

	Relative prices[a] at:						
	Official exchange rate				Effective export exchange rate		
	NIS exchange rate against:			4-currency basket[b]	5-currency basket[b]	Real wage per:	
	Dollar	5-currency basket	U.S./ Israel	countries/ Israel	countries/ Israel	unit of output[c]	day[d]
1983	0.056	0.051	96.8	80.0	95.25	102.80	95.26
1984	0.293	0.245	103.7	79.1	101.34	91.71	87.47
1985	1.179	1.000	118.2	90.4	110.07	82.29	81.60
1986	1.488	1.446	100.0	100.0	100.00	100.00	100.00
1983 I	0.037	0.035	95.7	81.9	94.01	107.36	97.07
II	0.043	0.040	93.0	78.7	96.35	104.45	97.83
III	0.056	0.050	96.0	77.3	95.19	107.45	99.34
IV	0.089	0.079	102.5	82.0	95.44	91.96	86.81
1984 I	0.131	0.115	102.9	82.2	97.40	91.15	84.79
II	0.192	0.168	102.5	81.4	104.77	91.46	88.38
III	0.311	0.260	103.1	76.8	103.60	91.47	88.39
IV	0.539	0.438	106.2	76.1	99.58	92.74	88.33
1985 I	0.733	0.572	115.6	78.7	107.59	88.93	85.94
II	1.015	0.827	119.6	87.3	112.40	84.05	84.57
III	1.487	1.273	123.5	97.7	112.16	75.95	73.89
IV	1.481	1.329	114.2	97.8	108.11	80.22	81.99
1986 I	1.486	1.387	108.3	101.0	106.92	96.88	93.98
II	1.485	1.420	100.9	99.8	100.79	101.28	101.45
III	1.491	1.481	97.2	101.5	98.03	97.26	98.86
IV	1.489	1.495	93.7	97.7	94.25	104.58	105.71
1987 I	1.601	1.660	96.7	106.8			

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

[b] Average of the representative rates; the 5-currency basket includes the U.S. dollar, DM, £, Ffr. and Yen, weighted by the composition of Israel's foreign trade. The 4-currency basket excludes the dollar.

[c] W/(PX*E*Y), where W—nominal daily wage in industry (excl. diamonds); PX—dollar price of industrial exports (excl. diamonds); Y—output per day in industry (excl. diamonds); E—effective exchange rate for exports.

[d] W/(PX*E).

SOURCE: Exchange rates and effective exchange rates—Bank of Israel; wholesale price index, export prices, wages and output—Central Bureau of Statistics; prices in the U.S. and currency-basket countries—IFS.

decline was recorded in 1986. In contrast, there was a marked increase in tourism and services n.e.s.; the rise in imports of tourist services is an additional reflection of the increase in private consumption.

Exports in 1986 were at a higher level than in 1985, having risen 4 percent in volume. The quantitative increase seems to have been influenced by the slow-down in the growth of international trade.[7] Not all export branches advanced; merchandise exports, excluding those to Judea, Samaria and Gaza, increased by some 7 percent in volume, compared with 5 percent in 1985, but exports of services (excluding capital services and exports to Judea, Samaria and Gaza) fell by 10 percent. Considering various factors that had an adverse effect on exports, the expansion of merchandise exports is remarkable; on the one hand, there was the negative effect of difficulties in specific branches and the weakening of the dollar, and on the other, the inconsistent changes, particularly in early 1986, in several nominal variables, such as wages, the exchange rate and others. These diverging changes were due to the steep fall in the inflation rate, which led to a rise in real wages, with an adverse effect particularly on exports, especially those priced in dollars (see Table VII–4). In addition, exports were influenced by the developments in domestic demand, and industrial exports were especially affected by the cuts in domestic defense spending. These cuts resulted in a contraction of output in the industries producing defense goods, but they also initiated a diversion of output from the domestic to the export market.

The European currencies continued to strengthen during the year, oil prices fell, and prices of other inputs rose slightly, but prices of imported and exported services as well as imported final goods rose, especially of consumer and capital goods and exported services, while prices of export goods rose only slightly. The expansion of domestic demand and the increase in the import surplus therefore occurred while the terms of trade improved by some 3 percent, and also expressed themselves in a real appreciation, reflected by the changes in the prices of imports and exports relative to those of domestic use of resources (see Table VII–1 and Figure VII–2).

In past years the government took no steps to directly reduce the current account deficit by cutting down domestic demand, and particularly the government's own demand; instead, it attempted to reduce the deficit by such policy measures as higher import taxes and export incentives, and nominal devaluations. Such a policy indeed leads at first to a relative cheapening of domestic goods, and thus to a temporary postponement of purchases of imported goods and more production of import substitutes and export goods; but in time (if there is no contraction of aggregate domestic demand), prices rise in line with the devaluation and the increase in taxes. The

[7] Indexes that may help to explain developments in Israel's exports are the index of world trade (Table VII–1), the index of exports of OECD countries, the index of world industrial production and that of industrial production in Western countries.

temporary improvement in the balance of payments therefore peters out, and the economy pays the price of such a policy in a higher level of inflation and misallocation of resources.

The above is not meant to deny altogether the importance of a nominal exchange rate policy. Nominal changes cannot translate into real changes unless macro-economic conditions are appropriate; but on the other hand, nominal rigidities may prevent real changes from materializing. A reduction of domestic demand without a change in GNP, for example, must express itself in a decrease of imports, accompanied by a real devaluation and a cut of real wages. If money wages are inflexible downwards, the improvement in the import surplus will not express itself in a real devaluation. In such a situation, a nominal devaluation becomes necessary to facilitate a real devaluation and a reduction of unemployment. In 1986 unemployment indeed increased while real wages rose; this has variously been regarded as evidence for the influence of nominal rigidities, which can be redressed by a nominal devaluation. It is, however, possible that the rise in real wages together with increasing unemployment in the year under review largely reflected the combined effects of changes in the structure of demand for labor and of institutional problems which might possibly be solved without resorting to devaluation.

It may be added that nominal devaluations involve risks: for example, the possible undermining of the public's confidence in the policy goal of price stability. When the government carries out a one-time devaluation under a fixed exchange rate regime in order to bring about an erosion of real wages, the public may once again come to expect such discrete adjustments of the exchange rate in the medium and long term; such expectations may lead to further wage increases, to buying sprees, and similar effects.

Table VII–4 presents some additional indexes illustrating the development of relative prices of Israel's foreign trade. The price index of tradables abroad relative to the price index of Israeli tradables (see also Figures VII–5 and VII–6) indicates the profitability of producing import substitutes and export goods, at least in the short term (in the long run prices of locally produced tradables must move in line with international equilibrium prices). After the introduction of the stabilization program and its one-time devaluation, this index rose by 7 percent (at the official exchange rate against the 5-currency basket; there was no change in terms of the effective exchange rate for exports, and by the end of the year it had been eroded by 15 percent). Real wages, measured in terms of the price of tradables, are another indicator of the profitability of exports[8] (see Figure VII–6). Real wages were eroded after the adoption of the stabilization program, but subsequently money wages rose again; by early 1987 these became real wage increases, part of which had been anticipated while another part was unforeseen. This process of real appreciation reflects the effects of both endogenous and

[8] The index actually expresses the share of wages in the industrial product destined for export.

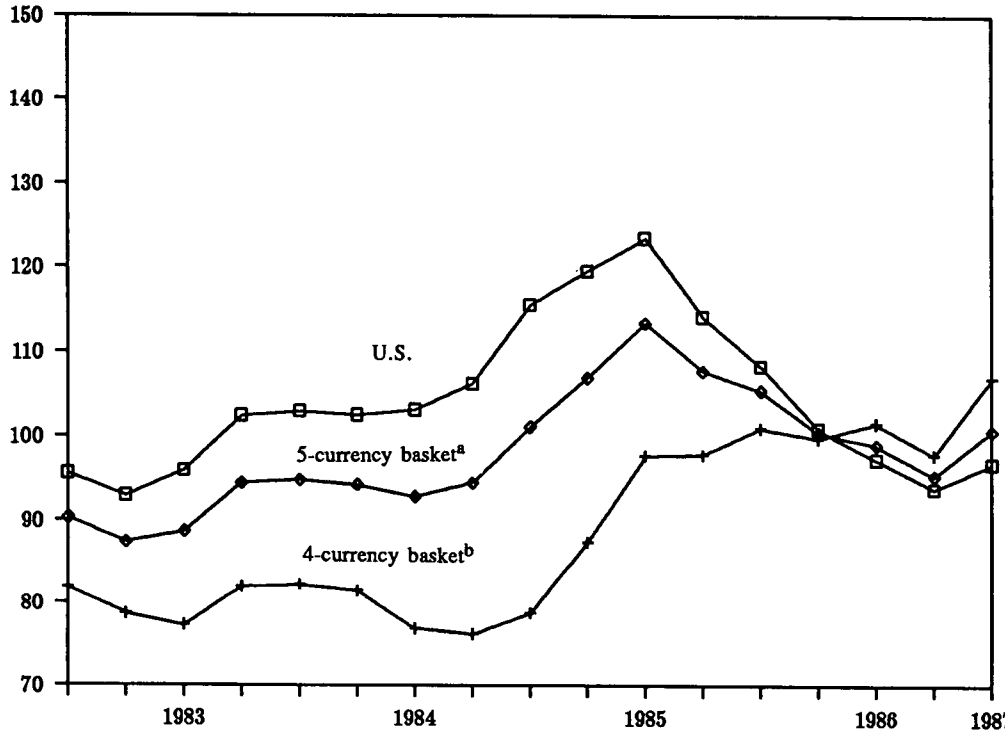
exogenous factors. One cause of the rise in real wages was that wage agreements concluded before July 1985 which had been suspended when the stabilization program was introduced, were now implemented; another cause were expectations that prices would rise more steeply than they did in fact, and expectations of devaluation in the course of the year. These, however, provide no full explanation for the rise in real wages.

The rise in real wages and the impairment of export profitability, together with the expansion of domestic demand, the growing trade deficit and the continued rise of domestic prices caused the government to take several measures in January 1987: the currency was devalued by some 10 percent, accompanied by a partial neutralization of its inflationary effect through a lowering of employers' national insurance contributions and the waiver of part of the cost-of-living allowance. It is still too early to evaluate the long-term effect of this policy. As stated earlier, a nominal devaluation becomes a real devaluation and a cut in real wages only if money wages are in fact inflexible downwards. In the first half of the year it indeed seemed that there had been an overshooting in nominal wage increases. The situation in the second half of the year is less clear, since the wage hikes occurred while unemployment declined and there was a rise in domestic demand and imports of production inputs and capital goods. The movement of wages and prices in the course of 1987 will show whether the January devaluation has achieved its purpose.

The composition of imports by final uses summarizes their distribution between intermediate and final goods. The composition by final uses (see Table VII–A2) reflects both the shifts in domestic demand and the changes in relative prices during 1986. As stated earlier, prices of imported intermediate goods declined relatively, and those of final goods went up. These price movements offset the influence of the quantitative shifts in domestic demand. This was conspicuous in exports and private consumption where the import component is high, and in fixed investment, in which imports are mostly of final goods.

Imports of final goods and services, and of services and intermediate goods for private consumption rose only slightly in the year under review although private consumption rose steeply. The share of intermediate goods for export production decreased slightly, despite the quantitative rise in exports and in imports of inputs for exports (see Table VII–A3). On the other hand, there was some increase in direct imports of final goods and imports of services and intermediate goods for the production of capital goods, despite the quantitative decline in fixed investment. Direct and indirect imports for public consumption, and particularly direct defense imports, continued to decrease in the year under survey.

Figure VII–4
RELATIVE PRICES OF INDUSTRIAL GOODS, U.S. AND CURRENCY-BASKET COUNTRIES/ISRAEL, 1983–86[a]
(Indexes, 1986 = 100, quarterly)



[a] Wholesale prices of industrial output abroad, in sheqel terms, divided by the relevant local prices.
[b] See note d to Table VII–5.

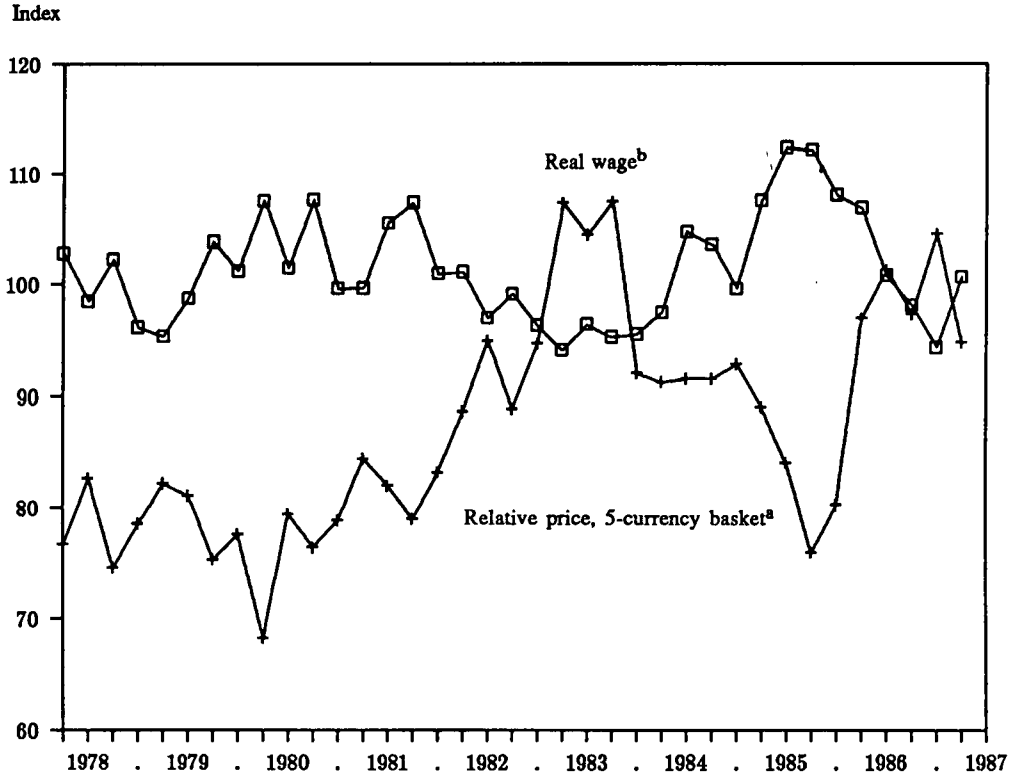
Merchandise Imports[9]

As already stated, the upswing in domestic demand, especially of private consumption and investment in stocks, resulted in a rising import surplus and higher imports. Civilian merchandise imports, excluding fuel and diamonds, increased some 18 percent in volume, following a 4 percent decline in 1985 (see Table VII–A1). Most of the increment went into private consumption, imports for which rose by 39 percent, and into imports of intermediate goods.

Table VII–5 shows that in the distribution of merchandise imports by countries of origin the share of European countries rose from 59 to 63 percent, while imports from North America decreased from 30 to 25 percent. This runs counter to what might have

[9] Excluding diamonds and imports from Judea-Samaria and the Gaza District.

Figure VII–5
REAL WAGES IN INDUSTRY, IN TERMS OF PRICES OF TRADABLES, AND RELATIVE PRICES, 1978–87 I
(At effective exchange rate; 1986 = 100)



[a] See note d to Table VII–5.
[b] See note b to Table VII–5.

Table VII–5
MERCHANDISE IMPORTS[a] BY AREA OF ORIGIN, 1981–86
(Percent of total, current $)

	1981	1982	1983	1984	1985	1986
Europe[b]	55	56	56	56	59	63
North America	30	29	29	31	30	25
Other	14	15	15	13	11	12
Total	100	100	100	100	100	100

[a] Excluding direct defense imports, fuel and raw diamonds.
[b] EEC and EFTA countries.

SOURCE: Central Bureau of Statistics.

been expected in view of the weakening of the dollar, but it must be kept in mind that these are not volume data, but percentage shares derived from data on current dollars. Since price indexes for different trade areas are not available, and considering the changes in relative prices between the U.S. and other countries due to the changes in exchange rates, there is no way to estimate the quantitative shifts in the composition of merchandise imports.

Preliminary data indicate that the effective taxation of imports (not including import deposits) rose slightly, but it seems that this was not due to changes in the rates of taxation, but to changes in the composition of imports: the rise in the share of imports of consumer goods (which are taxed heavily). However, the tax component in the import deposits decreased considerably owing to the reduction of the rate of deposits and the slow-down of inflation.[10]

Merchandise Exports[11]

The total quantitative increase in exports in 1986 was some 4 percent, but its components developed divergently. Merchandise exports, excluding diamonds, increased 7 percent by volume, while exports of services declined. The development of goods exports was also not uniform, neither in terms of prices nor of quantity (see Table VII–A4). The nonuniform development of exports was due to the different conditions in specific markets and to the rise of the European currencies against the dollar. Changes in different export branches were also influenced by developments in domestic output as compared with domestic demand. Particularly noteworthy was the expansion of exports classified as defense goods (metal products, electrical and electronic equipment, and transport goods). These branches increased their exports by 8 percent, while their product fell by 5 percent (see Chapter VI, the section on industry). This was due to the cut in domestic defence procurement.

Israel's main export markets are in Europe. In recent years the share of these markets in total exports has been declining, as exports were shifted to the U.S.A. (see Table VII–10); in 1986 this trend was checked, and exports to the U.S. declined. Once again, it should be kept in mind that these data are derived from export statistics in current dollar values; the lack of price indexes by trade area restricts the analysis.

[10] A rough estimate indicates that the tax element in the import deposits declined from about 40 to some 5 percent.

[11] Excluding diamonds and exports to Judea-Samaria and the Gaza District.

Table VII–6
MERCHANDISE EXPORTS[a] BY AREA OF DESTINATION, 1981–86
(Percent, current $)

	1981	1982	1983	1984	1985	1986
Europe[b]	45	42	45	42	40	41
North America	17	18	21	24	29	27
Other	38	40	34	34	31	32
Total	100	100	100	100	100	100

[a] Excluding polished diamonds.
[b] EEC and EFTA countries.

SOURCE: Central Bureau of Statistics.

The Services Account

The services account comprises two main categories: the capital services account, which represents net interest payments on the foreign debt, and miscellaneous current services. The total services account deteriorated steadily and rapidly from 1979, when imports and exports of services were balanced. The trend changed in 1985 and the import surplus declined to some $900 million, but in 1986 it increased again to about $1.3 billion. The entire deterioration is due to the decrease in the export surplus of services other than capital services (see Table VII–A5).

The deficit in the services account is mainly due to the import surplus of capital services. In 1986 this was reduced by $70 million as net interest payments to the rest of the world declined as a result of the continued fall in world interest rates together with a smaller decline in receipts of interest from the rest of the world. It should, however, be kept in mind that most foreign-currency assets are invested short term, so that the decline of interest rates reflects itself entirely in a decrease of receipts of interest. The opposite holds true for interest payments to the rest of the world, because long-term loans at a fixed interest rate weigh heavily in the external debt. The average rate of interest on the foreign debt reflects the world interest rates that prevailed some years ago; therefore, the recent fall in interest rates has not reduced the economy's net interest payments proportionately.

The export surplus of services other than capital services declined in 1986—as already mentioned, mainly due to a $270 million increase in imports of services, but partly also because exports of services (excluding to Judea-Samaria and the Gaza District) declined by $60 million.

The rise in imports of tourism figures prominently in the increase of imports of services. The increase was both a quantitative expansion and the result of the rise in the dollar prices of services as the European currencies appreciated against the dollar. The

upsurge in foreign travel of Israelis is part of the increase in private consumption. While imports of tourism rose, exports of tourism services dropped severely in quantity (at higher prices), following a steady growth in the previous three years. The principal causes for the drop in incoming tourism were the political conditions in the Middle East and the weakening of the dollar during 1986 (see Chapter VI, the section on tourism).

Exports of transport services have been stable since 1984, and their imports remained at the 1985 level. These developments reflect the expansion of Israel's foreign trade on the one hand, and the fall in transport prices on the other (see Chapter VI, the section on transport).

The biggest item in the services account (excluding capital services) is 'other services', imports of which had contracted in 1985 and increased again in 1986. However, this item includes 'services n.e.s.', the breakdown of which is not quite clear; it may include errors and omissions and capital movements not recorded in the capital account.

Unilateral Transfers

Total net unilateral transfers have doubled in the last decade: from an annual average of $2.6 billion in 1977–82, they rose to $5 billion in 1985 and $5.3 billion in 1986 (see Table VII–7). As a percentage of GNP the increase was smaller, rising from 15 percent of GNP in 1977–82 to an average of 22 percent in the last two years. Most of the increase in unilateral transfers is due to higher U.S. aid (see Table VII–8) and the change in its composition. From 1985, the entire military aid was given as outright grants,[12] whereas in the early 1980's 60 percent of it was given as long-term loans. The financing of defense consumption from loans resulted in an annual increase of $1 billion in Israel's debt to the U.S., cumulating to a total of $10 billion. The service on this debt, on account of principal and interest, mounted rapidly in recent years, while the civilian economic aid received as a grant also rose. A comparison of the civilian grant with the debt service to the U.S. between 1975 and 1986 shows that most of the civilian grant-in-aid (excluding the emergency grant of the last two years) was year after year repaid to the U.S. in payments of interest and principal of the debt. The civilian aid remaining after servicing the debt amounted to no more than $50 to $200 million a year (except in 1983). Until recently the repayment of Israel's debt to the U.S. was therefore financed from the civilian grant-in-aid; this burden may in fact have partly been the justification for the civilian grant. Nevertheless, a debt balance of some $10 billion was accumulated, carrying interest at an average of 10 percent p.a., which by itself is a heavy burden for many years ahead. The decision by the U.S. to resort no longer to loans for the financing of Israel's current defense consumption is therefore

[12] The loans received in 1986 utilized aid approved before 1985.

highly important as a long-run stabilizing factor in the balance of payments: on the one hand, the increase in the interest payments of the public sector will slow down (with a beneficial effect on the import surplus) and the rapid increase of the government's foreign debt will be checked. This is likely to improve the country's credit standing in international money markets and thus reduce the interest rates demanded on other loans taken up abroad, including those of the private sector.

In addition to the regular military and civilian aid, the U.S. has in the last two years given Israel a non-recurrent emergency grant of $1.5 billion, as a special aid to support the stabilization program. Half of this grant was received in 1985 and the other half in 1986.

Net unilateral transfers of the private sector increased from $800 million in 1985 to $1.1 billion in 1986, and thus regained their level at the beginning of the 1980s (see Table VII–14). This occurred as a result of two factors: one, the increase in the dollar value of unilateral transfers denominated in Deutschmarks, as the dollar depreciated in 1986 (this is especially noticeable in the $100 million increase in the dollar amount of restitution payments from Germany, which remained unchanged in DM); the other factor is related to considerations as regards the worthwhileness of capital imports, which also affect the volume of unilateral transfers by the private sector. Thus, the balance of payments crisis in 1983 and the public's apprehensions that financial assets might be taxed caused unilateral transfers to contract from 1983 until mid-1985, while private transfers to abroad increased.[13] This changed in mid-1985, after the stabilization program was introduced. The tranquillity that has prevailed since then and the development of domestic as against foreign interest rates made capital imports more worthwhile, and also affected the private sector's unilateral transfers. This is especially noticeable in 'personal remittances' (which increased by 57 percent from the first to the second half of 1986), and to a lesser degree also in the unilateral transfers of private nonprofit institutions.

[13] In 1984 the restrictions were tightened on private transfers to abroad, as support to family members and gifts to Israelis abroad.

Table VII–7
UNILATERAL TRANSFERS, 1977–86[a]
($ million)

	1977–81	1982	1983	1984	1985	1986
Private sector, net						
Personal restitutions from Germany	420	434	374	323	328	424
Personal remittances	508	544	553	425	367	593
Thereof: Immigrants	182	232	230	158	133	318
Others	326	312	323	267	234	277
Personal transfers in kind	25	21	21	20	16	21
Transfers of private nonprofit institutions	179	223	196	190	170	186
Private transfers to abroad	–83	–119	–162	–144	–81	–75
Total private sector						
Public sector	**1,047**	**1,104**	**983**	**815**	**803**	**1,149**
Transfers of national institutions	326	315	319	327	397	411
Intergovernmental transfers[b]	1,230	1,199	1,554	2,211	3,844	3,776
Total public sector	**1,557**	**1,514**	**1,873**	**2,538**	**4,241**	**4,187**
Total unilateral transfer	**2,603**	**2,616**	**2,855**	**3,352**	**5,043**	**5,336**

[a] Figures may not add owing to rounding.

[b] Includes military and economic grants.

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

Table VII–8
U.S. GOVERNMENT AID, 1977–86[a]
($ million)

	1977–81	1982	1983	1984	1985	1986
1. Grants	1,287	1,259	1,618	2,271	3,885	3,817
Thereof: Military	663	464	314	1,071	1,935	1,867
Civilian[b]	625	795	1,304	1,200	1,950	1,950
2. Medium and long term loans	1,075	1,081	1,092	898	0	405
3. Repayment of medium and long term loans	495	746	906	997	1,055	1,079
Thereof: Principal	211	177	156	124	109	133
Interest	285	569	750	873	946	946
4. Total gross aid (1+2)	**2,362**	**2,340**	**2,710**	**3,169**	**3,885**	**4,222**
5. Total net aid (4–3)	**1,867**	**1,595**	**1,804**	**2,171**	**2,830**	**3,142**
Thereof: Net receipts from loans	864	905	936	773	–109	271
Grants less interest payments	1,003	690	868	1,398	2,939	2,871

[a] Figures may not add owing to rounding.

[b] Includes the emergency grant of $750 million a year in 1985 and 1986.

3. THE CAPITAL ACCOUNT AND THE FOREIGN DEBT

The calm in the capital account that set in from mid-1985 continued throughout 1986. Capital exports of the private sector, which peaked in 1984, were checked and reversed during the year to become capital imports, which increased considerably in early 1987. The public sector account, however, recorded sizable net capital exports, reflecting the surplus accumulated in the current account: the entire short term foreign debt was already retired in 1985, while the foreign reserves increased by about half a billion dollars.[14] In 1986 the foreign currency reserves increased by an additional billion dollars, and during the year $700 million were paid in advances on account of future defense imports.

The net external debt was reduced by $300 million in 1986, to a level of $19 billion[15] (see Table VII–13), with a considerable improvement in its composition: in 1986 the economy's liquid assets exceeded its current liabilities, so that the relatively easy debt structure that prevailed until 1982 was restored.

The overall economic stability and tranquillity, and particularly the continued stability of the exchange rate, increased the substitutability between the domestic and the international money market.[16] This causes capital movements to be highly sensitive to the gap between domestic and international interest rates. Although this turn of events places restrictions, in the short term, on the determination of local interest rates, it has long-run advantages analogous to those of opening the economy to international merchandise trade. The greater substitutability of the local and the foreign money markets developed while controls of capital movements were tight and extensive in scope; if Israel falls in with the world-wide trend of liberalizing the controls on capital movements, this substitutability is likely to increase. Such liberalization requires caution and a gradual approach, particularly in view of past experience in Israel and in other countries. Greater perfection of the Israeli money and capital markets and the emergence of a futures market for the sheqel further increase this substitutability, and may, through a greater integration into the international market, provide support for the

[14] Reserves held by central monetary authorities—see Table VII–12.

[15] The change in the net foreign debt is not equal to the current account surplus, for two reasons: a) the foreign debt is denominated in dollars, and the sharp depreciation of the dollar against the other major currencies expressed itself as a revaluation of the foreign debt in an amount of $300 million; b) the definition of the external debt does not include some of the assets held abroad (especially most of the assets held by the nonbanking private sector, and advances paid by the government on future defense goods imports. This biases the level of the foreign debt upwards, and changes in its level are also not necessarily consistent with changes in the current account.

[16] A provisional examination of developments in recent months indicates that the January 1987 devaluation has not affected this substitutability.

renewal of economic growth—both by augmenting investment by foreign corporations and by enabling Israeli firms to raise long term loans in the international market for the financing of their investments.

The large size of the foreign debt requires that it be managed carefully and efficiently. Until now the principal emphasis in the management of the foreign debt was on the liquidity structure of the debt, with the result that the economy's liquid assets exceeded current liabilities. In addition, the rapid mounting of the government's external debt was checked by the change in the form of U.S. military aid. These developments would seem to lay the ground for giving the private sector easier access to the international capital market, while putting the emphasis on setting the cost of capital to the individual investor equal to its cost to the economy as a whole.

The activities of the Israeli banking system provide an indication of the economy's ability to raise capital at international costs—provided the appropriate infrastructure for the mobilization of such capital exists. In the last decade the Israeli banking system has considerably expanded its international operations through its overseas subsidiaries and affiliates, and has succeeded in raising capital at a lower cost than other firms and institutions, including the government itself (for example, through the Israel Bonds). The banks are restricted in raising capital abroad, both for reasons of maintaining monetary restraint at home, and in order to safeguard the banks' stability. They have therefore not exhausted their potential of raising funds abroad. A cautious expansion of the existing infrastructure for the raising of funds abroad and for its diversification, by having economic enterprises and institutions join in, might give further support to the revival of economic growth in the future.

The foreign currency reserves rose to $4.9 billion at the end of 1986—a high level in comparison with previous years. The entire current account surplus went to increase the reserves, while the gross external debt increased slightly (even after adjustment for the changes in exchange rates). This had its reason in the different ways in which the balance of payments was affected by the public sector versus the private sector. The current account surplus of the last two years had its origin in government operations, and was partly of a temporary nature. The government used the current account surplus to repay the entire short-term debt, while continuing modest long-term borrowing, and the rest of the surplus went to increasing the foreign reserves. Operating under conditions which particularly restrained capital exports (see below), the private sector therefore reduced its purchases of foreign currency from the Bank of Israel, increasing its external debt from mid-1985. The combined effect of the activities of the two sectors was a rapid rise of the foreign reserves.

A high level of foreign reserves enhances the central bank's ability to meet sudden or unexpected surges in the demand for foreign currency (which may be caused by external or domestic factors), while keeping the exchange rate stable. It can therefore be said that the rise in the foreign reserves was consistent with the government's greater

Table VII–9
BALANCE OF PAYMENTS OF THE PRIVATE AND THE PUBLIC SECTOR, 1981–86[a]
($ million, current prices)

	1981	1982	1983	1984	1985	1986
Public sector						
1. Goods and services account	–2,615	–2,071	–1,810	–2,559	–3,124	–2,359
2. Unilateral transfers	1,725	1,512	1,872	2,537	4,240	4,187
3. Subtotal: Current account	–890	–559	62	–22	1,116	1,828
4. Medium and long term capital movements	1,323	1,253	1,281	1,103	5	342
5. Basic account	433	694	1,343	1,081	1,121	2,170
6. Short term capital movements	399	52	–480	426	–148	–723
7. Capital movements of the banks on behalf of the public sector	743	976	–118	285	159	50
8. Errors and omissions[b]	–618	–291	278	–301	338	154
9. Effect of public sector on foreign reserves [increase (–)]	–957	–1,431	–1,023	1,491	–1,471	–1,651
Private sector						
1. Goods and services account	–1,634	–2,499	–3,051	–2,257	–821	–1,607
2. Unilateral transfers	1,200	1,104	983	815	803	1,149
3. Subtotal: Current account	–434	–1,395	–2,068	–1,442	–18	–458
4. Basic account[c]	–489	–1,515	–1,000	–1,269	–59	–498
5. Medium and long term nonbanking capital movements	–55	–120	1,068	173	–41	–40
6. Short term nonbanking capital movements	52	280	64	79	–119	20
7. Capital movements of the banks on behalf of the private sector	19	683	370	–392	–163	–127
8. Errors and omissions[b]	38	40	–1,022	–418	–730	–55
9. Effect of private sector on foreign reserves [increase (–)]	380	512	1,588	2,000	1,071	659
10. Implied capital imports of the private sector –(3+9)	54	883	480	–558	–1,053	–201

[a] Figures may not add owing to rounding.

[b] Residual, putting the sum of rows 5, 6, 7 and 9 equal to zero. For the public sector, errors and omissions therefore include foreign currency transactions between the government and the private sector, excluding purchases of foreign currency by the private sector from the Bank of Israel, which are recorded in row 9 of the public sector balance of payments.

[c] Rows 1 to 5— from Table VII–2.

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

commitment, in the framework of the stabilization program, to maintain the stability of the exchange rate. When the economy is a net borrower, the holding of foreign reserves involves the cost of the difference between the marginal interest rates on the debt and on the reserves, respectively. It may be assumed that recent developments in the balance of payments have narrowed this difference.

The scope of the public sector's operations in the current and capital account of the balance of payments makes it necessary to distinguish, for the purpose of analysis, between the public and the private sector. Although this distinction involves conceptual and statistical difficulties and should be taken as no more than an approximation to actual developments, it is important for the analysis of the balance of payments (see Table VII–9).[17]

The public sector's operations on capital account were determined by its large current account surplus: $1.1 and $1.8 billion in 1985 and 1986 respectively (see Table VII–9). In previous years the current account position varied between balance and a deficit of up to $900 million.[18] A large part of the surplus accumulated in the last two years is transitory in character,[19] and was used for a considerable improvement of the public sector's balance of short-term assets and liabilities, while long-term borrowing continued on a modest scale.

Private capital exports ceased in the course of 1986 and reversed to become capital imports which in the first quarter of 1987 reached a sizable scale. From the end of 1983 until the introduction of the stabilization program in July 1985, the private sector exported capital on a substantial scale. These capital exports were among the principal causes of the liquidity crisis in the balance of payments, which reached its peak in 1984.

Private sector capital movements are subject to a broad range of controls which were further tightened in 1984; these controls have only recently been relaxed somewhat, and that only marginally.[20] The purpose of the currency controls was to restrict capital

[17] Two reservations ought to be emphasized: (a) The distinction between the import surplus in each of the two sectors is in part based on the estimate of direct government imports. This estimate is less reliable than the data on the capital account recorded by the sector carrying out the operations. Moreover, direct government imports should not be regarded as an estimator of the government's influence on the current account, which is affected, in no lesser degree, by the scope of the government's domestic activity. (b) In addition to purchases of foreign currency from the Bank of Israel, the two sectors carry out other foreign-currency transactions with each other. No direct data on these are available, so that they are included in 'errors and omissions' of the two separate balances of payments. This is one reason for the large size of the E&O item in the separate balances relative to its level in the combined balance of payments.

[18] Except for 1979, when a $300 million surplus was recorded in the public sector's current account.

[19] The two principal temporary components are the U.S. emergency grant of $750 million annually in the last two years, and the temporarily low level of direct defense imports in 1986—$1.2 billion as compared with an average annual level of $1.5 billion in the last five years. When advances on account of future defense imports are included, defense imports in 1986 reached $1.8 billion.

[20] The changes in the foreign currency controls are described in Chapter IX of the Annual Report.

outflows during the years of balance of payments difficulties and to prevent speculative short-term capital inflows when domestic interest rates are higher than international interest rates. A regime of currency controls has side effects in causing distortions because firms are hampered in the efficient conduct of their business abroad. It is, moreover, reasonable to assume that when currency controls are in force for a long time, the public learns how to evade them. One result is that the statistical reports on private capital movements deteriorate, which hampers analysis.

The reported direct short-term capital imports of the nonbanking private sector have in recent years not been a reliable estimator of the amplitude of short-term speculative capital movements, and sometimes not even of their direction. The data on capital imports through the banking system are more reliable, but this route is controlled tightly. For the analysis of capital movements it is therefore necessary to resort to alternative indicators.

The implied 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, in all components. The general indication provided by this figure is that capital exports were checked during 1986 (see Table VII–9). Partial data available indicate that there have been considerable capital imports in the first few months of 1987.

An examination of the various components of private capital movements and indicators for capital movements that are not fully reported, clearly point in the same direction. Thus, for example, there has been a 50 percent rise in the private sector's unilateral transfers[21] (see section 2 in this chapter and Table VII–7). Direct investment by foreigners has also increased. These two modes of capital movements are relatively free of controls. The change in the 'errors and omissions' item in the private sector's balance of payments (which includes part of the unreported capital movements) is also consistent with this trend.

A further indication is to be found in a comparison of the private sector's balance of payments on a cash basis with those of the conventional balance of payments.[22] This points to capital imports in an amount of some $500 million in 1986, derived from the merchandise account (half of this sum represents an increase in suppliers' credit for imports, and the other half—a decrease of credit to customers for exports). Provisional data for the first quarter of 1987 indicate rising capital imports. From a similar examination of import and export data of tourism and the items of unilateral transfers by individuals it is possible to arrive at a partial estimate of the leakage of foreign currency

[21] Unilateral transfers of the private sector are part of the current account, since they create no matching liability to the rest of the world. Their size, however, is influenced by considerations akin to those relating to capital imports.

[22] See the survey of the Controller of Foreign Currency, *Foreign Currency Receipts and Payments*, Hebrew, published in May 1987.

Table VII–10
MEDIUM AND LONG TERM FOREIGN BORROWING, 1981–86[a,b]
($ million)

	1981	1982	1983	1984	1985	1986
Total receipts from loans	2,447	2,410	2,833	2,325	1,213	1,757
Public sector	2,067	1,980	1,894	1,741	741	1,227
Thereof: State of Israel bonds	525	549	463	471	525	613
U.S. government loans	1,111	1,081	1,092	898	0	405
Nonbanking private sector	380	430	939	584	472	529
Total loan repayments	1,173	1,075	948	1,033	1,224	1,500
Public sector	771	727	614	638	735	885
Thereof: State of Israel bonds	441	399	332	313	312	371
U.S. government loans	206	177	156	124	109	133
Nonbanking private sector	402	348	334	395	488	615
Total net receipts from loans	**1,274**	**1,335**	**1,885**	**1,292**	**–11**	**256**
Public sector	1,296	1,253	1,281	1,103	5	342
Thereof: State of Israel bonds	85	150	131	157	213	243
U.S. government loans	905	905	936	773	–109	271
Nonbanking private sector	–22	82	605	189	–16	–86

[a] Figures may not add owing to rounding.
[b] Excludes the banking system.

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

outside the banking system (for direct holding of cash foreign currency by individuals or in unreported accounts abroad). This estimate indicates an accumulation of foreign currency holdings of some $1.5 billion in 1983–84, a further increase by about $500 million in 1985 (mostly in the first half of the year), and a decrease of $500 million during 1986—mostly in the second half of the year.

ESTIMATED LEAKAGE OF FOREIGN CURRENCY OUTSIDE THE BANKING SYSTEM, 1983–86
($ million)

	1983	1984		1985		1986	
		I–VI	VII–XII	I–VI	VII–XII	I–VI	VII–XII
Total leakage	830	290	330	355	125	–55	–395
Thereof: Outgoing tourism	700	60	20	–40	–120	–150	–250
Incoming tourism	80	150	240	275	205	80	10

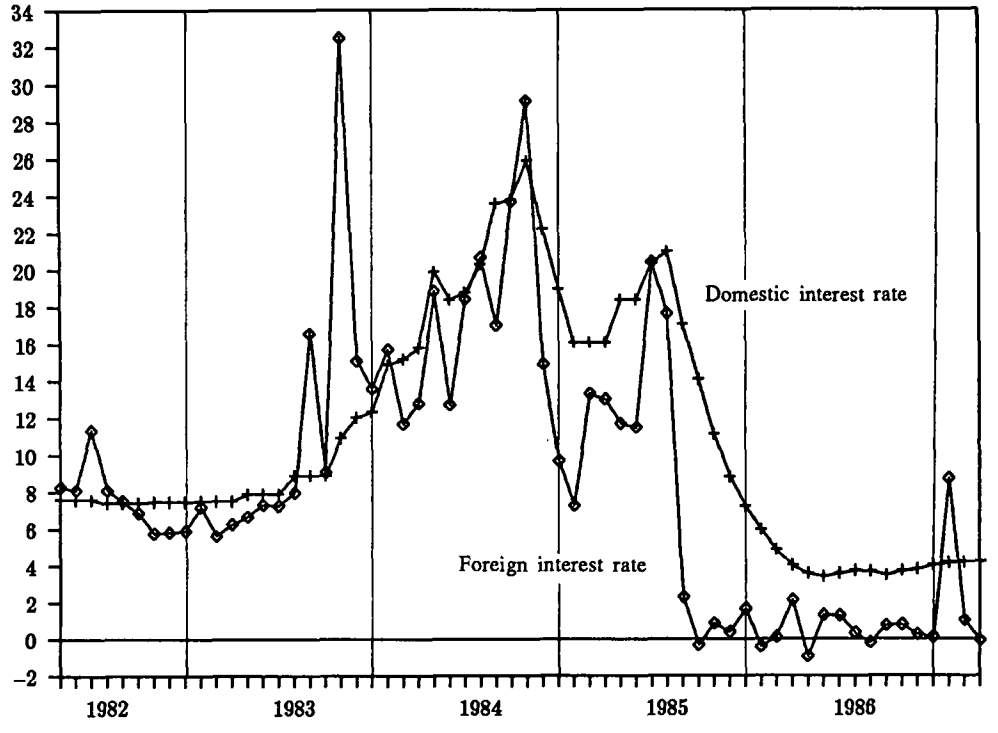
SOURCE: Controller of Foreign Currency, Bank of Israel.

In conclusion, it may be said that in the course of 1986 short-term capital imports seem to have considerably exceeded the private sector's short-term foreign borrowing as reported in the balance of payments. These movements are explained by the existing currency controls, which are intended to curb such movements.

The picture that emerges from the above analysis is supported by an examination of the movement of interest rates at home and abroad for the private sector. Short-term capital movements that exceed the financing requirements of the current account deficit are influenced by portfolio considerations—the worthwhileness of holding assets and taking up loans in local currency as against that of holding assets and borrowing abroad. Capital imports can therefore be expected to increase when: (a) interest rates on local currency assets and credit are higher than the anticipated interest rate on foreign-currency assets and loans; (b) when the uncertainty in predicting

Figure VII–6
THE GAP BETWEEN DOMESTIC AND FOREIGN INTEREST RATES, 1982–87 I

Percent



DEFINITIONS:

Domestic interest rate—monthly interest rate on local-currency credit (effective rate on overdraft facilities).

Foreign interest rate—3-month Eurodollar rate, monthly, multiplied by inflation rate.

SOURCE: Bank of Israel.

interest rates abroad is smaller, or that of predicting domestic interest rates is higher; (c) when apprehensions abate that the government may take measures such as taxing financial assets; and (d) when foreign currency controls are relaxed.

The main cause of uncertainty is that interest rates are nominal for each currency; their equalization requires prediction of the changes in exchange rates that may occur until loans fall due for repayment or assets are realized.

Table VII–11 and Figure VII–6 show the interest rates *actually* paid on local-currency credits, and the Eurodollar rate abroad.[23] Short-term capital inflows are supposed to be consistent with the difference between the interest rate on local-currency credits (overdraft facilities) and interest rates abroad (since domestic bank credit in foreign currency was in recent years restricted by credit ceilings). The development of the *actual* interest rate gap was not consistent with capital exports, which kept rising throughout 1984 and the first half of 1985, and with their gradual halt subsequently. This development becomes more understandable if the influence of the public's fear of taxes on financial assets is taken into account, as well as the uncertainty of predictions of the interest rate, which is related to expectations of devaluation. The fluctuations in the actual interest rates may be an indicator of this uncertainty because it is reasonable to assume that forecasting the interest rate becomes more difficult as actual interest rates fluctuate more widely. Prominent in Figure VII–5 is the sharp narrowing, after the stabilization of the exchange rate in July 1985, of the amplitude of fluctuations of actual interest rates on foreign-currency credits (in local-currency terms). Confidence in the government's intent of keeping the exchange rate stable and in its ability to do so increased gradually from mid-1985, and the apprehensions abated that financial assets might be taxed. This supported the decrease in general uncertainty, and came in addition to the reduction of the specific uncertainty related to interest rates discussed above. It seems that the ability of individuals to predict with relative certainty the interest rates on foreign-currency assets and credit—a consequence of exchange rate stability—significantly helps to maintain a close connection between the interest rate differential and capital imports.

Another indicator of uncertainty (related to the difficulty of predicting devaluation) is information on the black market dollar exchange rate. The premium on the black market dollar reflects expectations of devaluation and, when the exchange rate is

[23] Lending rates have been used here, but the use of borrowing rates would show a similar picture. The gap between interest rates on foreign currency versus local currency is meant to reflect not only the expected depreciation and the uncertainty in predicting it, but also the differences in the kind of credit—overdraft facilities as compared with fixed-term credit for three months. When comparing the comparative cost of these two kinds of credit, this introduces a further cause of uncertainty because the interest rate on overdraft facilities three months ahead must be predicted. This uncertainty exists throughout the period, with varying intensity, but would nevertheless seem to be of secondary importance for the explanation of capital movements in the period under review.

Table VII–11
PRIVATE SECTOR CAPITAL IMPORTS AND INTEREST RATE DIFFERENTIALS, 1982–87 I

		$ million	Percent[a]			
		Derived capital imports of private sector	Local currency interest rate	Foreign interest rate	Average monthly gap between local and foreign interest rate	Black market premium on the dollar
		(1)	(2)	(3)	(4)	(5)
1982	I	193	7.8	7.3	0.5	–
	II	–196	7.6	11.4	–3.7	–
	III	564	7.4	6.9	0.5	–
	IV	322	7.5	5.9	1.6	–
1983	I	161	7.5	6.3	1.3	–
	II	336	7.9	7.3	0.6	–
	III	427	8.9	9.1	–0.2	–
	IV	–444	12.3	13.6	1.3	12.5
1984	I	–131	15.8	12.8	3.0	6.8
	II	–92	18.8	18.4	0.4	28.1
	III	–177	23.8	23.7	0.1	8.9
	IV	–158	19.0	9.7	9.3	10.2
1985	I	–322	16.1	13.1	3.1	19.4
	II	–320	20.4	20.4	0.0	19.0
	III	30	14.1	–0.3	14.4	9.7
	IV	–440	7.2	1.7	5.5	8.4
1986	I	–163	4.0	2.1	1.9	8.5
	II	26	3.6	1.3	2.3	6.6
	III	–26	3.5	0.7	2.7	1.9
	IV	–38	4.0	0.1	3.9	0.9
1987	I[b]	–	4.2	–0.1	4.2	–1.7

[a] Differences due to rounding.

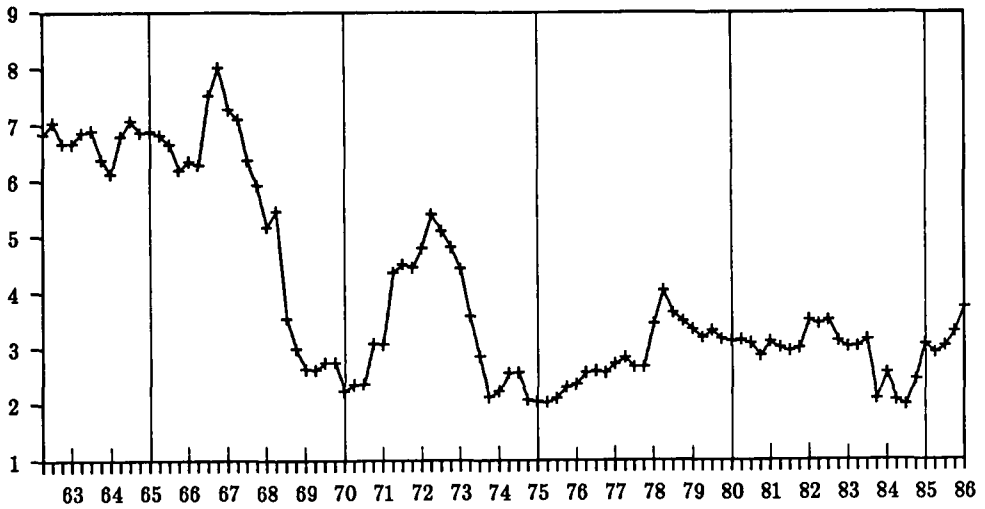
[b] A preliminary estimate of derived capital imports for this quarter on the basis of data on purchases of foreign currency from the Bank of Israel indicates capital imports of some $400 million or more in the first quarter of 1987.

DEFINITIONS:

(1) The difference between purchases of foreign currency of the private sector and its current account.
(2) Effective monthly interest rate on overdraft facilities.
(3) Eurodollar rate for 3 months, monthly.
(4) Difference between columns (2) and (3).
(5) Black market dollar rate relative to representative rate.

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

Figure VII–7
FOREIGN CURRENCY RESERVES IN TERMS OF IMPORT MONTHS COVERED, 1963–86



DEFINITION: Balances of the central monetary authorities at the end of the quarter, divided by the average monthly imports of the four preceding quarters.

SOURCE: Central Bureau of Statistics.

actually stable (as it has been from mid-1985 to the end of 1986) it is a yardstick of the error in predicting devaluation. The black market premium declined gradually during the period under review, but fell close to zero only in the second half of 1986.

There have been no significant changes in the currency control regulations from the introduction of the stabilization program until the end of 1986, so that there is no explanation of capital movements in this area.

In conclusion it may be said that from mid-1985 individuals perceived a gradually rising substitutability between holding assets and taking up credits in local and foreign currency. Combined with high local interest rates, relative to those abroad, this substitutability explains the diminishing export of capital and its reversal to capital imports on a substantial scale in the first months of 1987. This development, a result of the stability that has been attained, narrows the gap that can be maintained between interest rates on local currency and those prevailing abroad without causing considerable capital movements.

Table VII–12
RESERVES HELD BY CENTRAL MONETARY INSTITUTIONS, 1978–86[a]

		Central monetary institutions	Bank of Israel		Import months covered[c]
			Total	Net[b]	
1978		2,783	2,679	2,275	3.4
1979		3,234	3,119	2,588	3.3
1980		3,526	3,394	2,784	3.1
1981		3,814	3,542	2,847	3.1
1982		4,317	3,836	2,994	3.5
1983		3,780	3,694	2,873	3.0
1984		3,255	3,098	2,601	2.6
1985		3,793	3,719	3,190	3.1
1986		4,868	4,703	4,153	3.7
1983	I	4,195	3,962	3,196	3.4
	II	4,250	3,946	3,181	3.5
	III	3,847	3,765	2,954	3.1
	IV	3,780	3,694	2,873	3.0
1984	I	3,837	3,786	2,995	3.0
	II	3,985	3,796	2,954	3.1
	III	2,655	2,593	2,088	2.1
	IV	3,255	3,098	2,601	2.6
1985	I	2,635	2,624	2,130	2.1
	II	2,554	2,459	1,952	2.0
	III	3,020	2,935	2,423	2.4
	IV	3,793	3,719	3,190	3.1
1986	I	3,575	3,510	3,000	2.9
	II	3,737	3,619	3,098	3.0
	III	4,236	3,632	3,103	3.3
	IV	4,868	4,703	4,153	3.7
1987	I	..	4,838	4,290	..

[a] End of period.

[b] Total less reserve deposits on foreign residents' accounts.

[c] First column divided by average monthly imports in the period.

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

The Foreign Debt

Following more than a decade of rapidly rising net foreign debt[24] (on average, by 16 percent a year between 1973 and 1984), it was reduced by $400 million in 1985 and by an additional $300 million in 1986.

An analysis of the external debt poses two basic questions: first, to what degree does the foreign debt depart from the desired path; and second, how is the debt 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 country's basic economic condition, and the second, mainly to problems of liquidity, the ability to recycle the debt, and its cost.

The evaluation of the debt relative to its desirable size and growth usually compares the size of the debt with GNP. Disregarding temporary increases of the debt in response to unforeseen shocks, the motive for a continued accumulation of foreign debt may be the desire to take advantage of worthwhile investment opportunities or the desire to advance consumption in the expectation of economic growth in the foreseeable future. An accumulation of debt for these two purposes will be paralleled by economic growth, with little time lag.

Figure VII–7 shows the development in the ratio of foreign debt to GNP, according to two alternative definitions. Curve 2 is adjusted for the fluctuations in the dollar value of the GNP due to devaluations or real appreciation. Nonetheless, both curves are biased upwards for the years when the European currencies appreciated against the dollar, and vice versa when they depreciated. This is because the foreign debt is denominated in dollars and deflated by world inflation, but not adjusted for the changes in foreign cross rates. Both curves exhibit an improvement in the ratio in 1986, but in both it is biased downwards, and for 1985 it is not visible at all, despite substantial repayments of foreign loans.

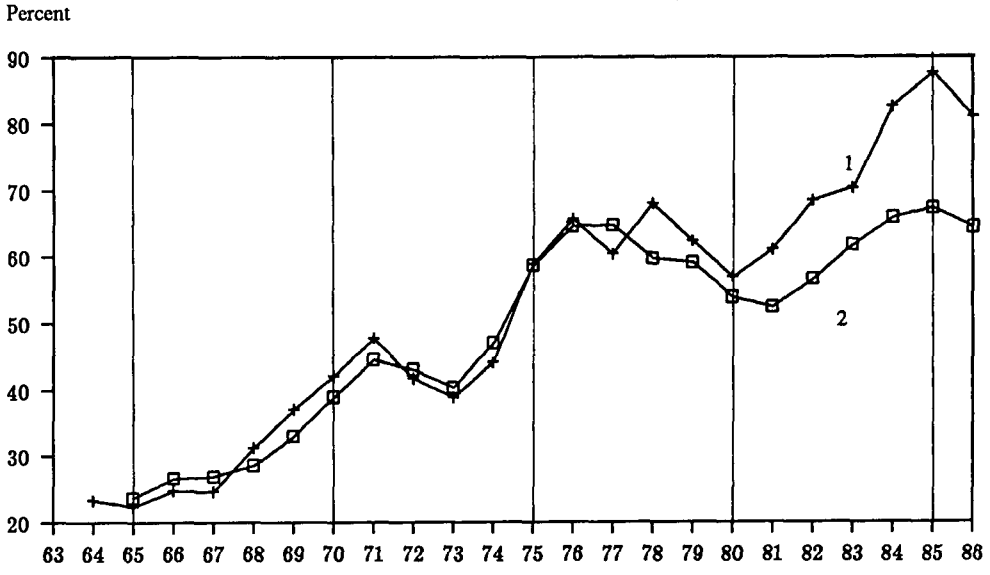
The international credit standing of a borrowing country is determined, among other factors, by the structure of the debt. Israel's foreign debt structure differs markedly from that of other borrowing countries, and affords the country easier access (at a given level of external debt) to the international capital market. Several characteristics of the foreign debt contribute to this situation (see Table VII–14): (a) The principal debtor is

[24] The net foreign debt (section 1, Table VII–13) is defined as total liabilities to the rest of the world (the gross foreign debt, row 8 in Table VII–13), less part of the foreign currency assets. Assets of the nonbanking private sector are not deducted, except for the balances in the 'Export Shipment Fund'. Advances on future imports of defense goods are also excluded from assets. In view of the rapid increase in the assets and liabilities of the Israeli banks abroad while their net liabilities grew only slowly, an additional definition has been adopted (line 2 in the table), which sums the gross debt of the government and the banking system and the net debt of the banks.

the public sector, accounting for 59 percent of the total foreign debt. Although this share has declined somewhat in the year under review, it is still large by international standards. The public sector is commonly seen as presenting a lower risk than private borrowers. (b) The country possesses net claims on the international banking system in amounts accounting for 22 percent of the net external debt. This advantage in Israel's debt structure is conspicuous when compared with the developing countries, which owe the greater part of their foreign debt to the international banking system. Some 61 percent of Israel's total net debt is owed to the public sector abroad. The considerations guiding that sector—in case of difficulties in servicing the debt—are not exclusively commercial. (c) The term structure of the debt is a further indication of the probability of running into difficulties in recycling the debt. In this regard, Israel's situation is particularly favorable: its liquid assets exceed the country's total short-term liabilities (including repayment of long-term debts falling due within a year).

Table VII–15 presents the conventional indicators for the foreign debt burden. Most of them point to a slight improvement in 1986. Some of these indicators do not properly

Figure VII–8
NET FOREIGN DEBT AS PERCENT OF GNP, 1964–86



DEFINITIONS:
Net debt in dollar terms—deflated by the average consumer price index of the industrialized countries.
Line (1)—the net debt in dollar terms divided by the GNP in dollar terms, at the official exchange rate.
Line (2)—the net debt in dollar terms divided by the GNP in dollar terms at 1963 prices.

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

reflect the improvement that has taken place in the country's external position. Thus, for example, the burden of debt service has remained approximately constant because the repayment of principal included in it has increased steeply in the last two years—as such, a desirable event. The average interest rate on the foreign debt has risen—a development related to the decline in international interest rates: since most of the country's foreign-currency assets are invested short term, any decline in world interest rates expresses itself in falling receipts from interest. In contrast, the external debt largely consists of long term loans carrying a fixed interest rate. The average interest rate on the foreign debt therefore reflects the interest rates that prevailed several years ago, and the current fall in interest rates therefore reduces it only partly. This has had the result that the share of net interest payments in exports and in the income available to the economy has declined slightly, but still remains high relative to previous years.

Table VII–13
ASSETS AND LIABILITIES IN FOREIGN CURRENCY, 1982–86[a]
($ million)

	1982	1983	1984	1985	1986
1. Net liabilities (2–3–4)	15,641	18,270	19,686	19,315	18,998
2. Liabilities	20,916	22,825	23,670	23,952	24,776
Government	13,378	14,789	15,580	15,521	16,133
Nonbanking private sector	2,723	3,159	3,410	3,746	3,932
Banking system, net	4,815	4,877	4,680	4,685	4,711
3. Foreign reserves	4,317	3,780	3,255	3,793	4,868
4. Exporters' credit to foreigners	958	774	728	906	910
5. Current liabilities	4,052	4,718	4,730	4,829	4,704
Banking system (short term)	2,094	2,444	2,388	2,301	2,110
Nonbanking private sector (short term)	1,010	1,021	960	1,048	1,227
Direct government debt (short term)	0	220	158	2	0
Medium and long term debt repayable within a year	948	1,033	1,224	1,478	1,367
6. Net current liabilities (5–3–4)	–1,223	163	746	192	–1,074
7. Net current debt as percent of net debt	–8	1	4	1	–6
8. Gross liabilities	28,109	29,670	30,299	30,332	31,464

[a] Figures may not add owing to rounding.

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

Table VII-14
STRUCTURE OF THE NET FOREIGN DEBT, 1982–86
(Percent of total net debt, end of period)

	1982	1983	1984	1985	1986
By borrower					
Public sector[a]	58	60	63	61	59
Private sector	42	40	37	39	41
Nonbanking private sector	11	13	14	15	16
Banking system	31	27	24	24	25
Total	**100**	**100**	**100**	**100**	**100**
By lender					
Foreign public sector[b]	60	56	56	57	61
Foreign nonbanking private sector[c]	56	54	51	54	60
Banking system abroad[d]	–17	–10	–7	–12	–22
Total	**100**	**100**	**100**	**100**	**100**
By term[e]					
Long and medium	114	105	102	107	113
Thereof: Repayable within one year	6	6	6	8	7
Short-term	–14	–5	–2	–7	–13
Total	**100**	**100**	**100**	**100**	**100**

[a] Government and Bank of Israel.

[b] Foreign governments and international institutions.

[c] Mainly foreign residents' deposits and State of Israel bonds.

[d] Comprises the country's foreign reserves and loans to Israelis by foreign banks and overseas offices of Israeli banks.

[e] Short term debt is defined as liabilities due for repayment within one year; the rest is defined as medium and long term debt.

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

Table VII–15
INDICATORS OF THE FOREIGN DEBT BURDEN, 1981–86[a]

	1981	1982	1983	1984	1985	1986
$ million						
Interest on gross debt	2,215	2,605	2,500	2,822	2,651	2,459
less Interest receipts	1,459	1,682	1,469	1,166	950	863
Interest on net debt	755	923	1,031	1,656	1,701	1,596
Other capital services						
Debit	115	138	166	143	123	131
less Credit	56	109	116	26	89	63
Repayment of principal	1,173	1,075	948	1,033	1,224	1,500
Total net debt service	1,988	2,026	2,030	2,806	2,959	3,164
Percent						
Interest/net debt[b]	6	7	6	9	8	8
Real interest[c]/net debt	–4	–1	1	4	4	6
Interest/net available resources[d]	3	4	4	6	6	5
Net interest/exports[e]	8	11	12	18	17	15
Net debt service/exports	22	24	24	30	30	29
Net debt service/exports + unilateral transfers	17	18	18	22	20	20
Net debt service/GNP	9	9	8	12	13	12

[a] Figures may not add owing to rounding.

[b] Calculated with debt lagged six months.

[c] Deflated by five-year average of CPI for industrial countries, to express long-term expectations of inflation.

[d] Dollar value of GNP plus unilateral transfers.

[e] Exports f.o.b., excluding capital services.

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