CHAPTER III

THE BALANCE OF PAYMENTS GENERAL SURVEY

Israel balance of payments deteriorated noticeably in 1979, after improving appreciably in 1976-77 and holding steady in 1978. The turn for the worse in the year reviewed can be ascribed to the 55 percent growth of the real import surplus of the private sector[1] and the need for short-term capital imports to finance the trade deficit, for the first time since 1975 (see Table III-1, line 5). It should nevertheless be noted that the swelling of the import surplus was due to factors specific to 1979 rather than any long-run trend.

The much larger import surplus is explained by four major factors. The one directly responsible was a significant worsening of the terms of trade caused by the 112 percent jump in oil prices during 1979.[2] The other factors, which mainly increased the surplus in quantitative terms, were as follows:

(a) Expectations of a continuation of the vigorous economic expansion begun in 1978, which was fueled by the growth of domestic demands after they had subsided in 1976-77.

(b) The appreciable upvaluation of the Israeli pound at the end of 1978 and beginning of 1979, which checked the rising trend in the relative prices of exports and imports[3] evident in 1975-77 (see Table III-4).

(c) The large liquidity injection (which was absorbed through the sharply higher basic balance of payments deficit[4] of the private sector). The source of the injection in the first half of the year was the substantial volume of credit raised abroad by banks (mainly between December 1978 and February 1979, when the Bank of Israel introduced various measures to staunch the inflow). In the second half of the year the injection was generated by the government and the Bank of Israel (see Table XVIII-4).

The impact of the last three factors waned toward the end of the year, leading to

[1] The nominal increase deflated by the rise in export prices. The impact on the balance of payments of global inflation exclusive of the change in the terms of trade is discussed in section 2.
[2] The fourth quarter of 1979 compared with the same period the year before.
[3] The prices of exports and imports relative to those of domestic uses, at factor cost.
[4] The import surplus (goods and services), less unilateral transfers and long- and medium-term capital imports.

Table III-1

DEFICIT ON GOODS AND SERVICES,[a] UNILATERAL TRANSFERS, AND CAPITAL ACCOUNT, 1975-79

($ million, at current prices)

					1979				
	1975	1976	1977	1978	Total	I	II	III	IV
1. Deficit on goods and services[a]	4,106	3,200	2,563	3,349	3,757	920	801	1,097	939
Private sector	1,938	1,366	1,145	1,332	2,369	603	456	782	528
Public sector[b]	2,078	1,834	1,418	2,017	1,388	317	345	315	411
2. Unilateral transfers	1,772	2,210	2,082	2,400	2,281	718	556	419	588
Private sector	732	683	811	907	1,057	264	258	262	273
Public sector	1,040	1,527	1,271	1,493	1,224	454	298	157	315
3. Deficit on current account (1-2)	**2,244**	**990**	**481**	**949**	**1,476**	**202**	**245**	**678**	**351**
Private sector	1,206	683	334	425	1,312	339	198	520	255
Public sector	1,038	307	147	524	164	137	47	158	96
4. Net medium- and long-term capital imports[c]	1,555	1,043	639	1,111	1,172	376	270	127	399
Private sector	151	174	105	192	102	3	10	14	75
Public sector[d]	1,404	869	534	919	1,070	373	260	113	324
5. Basic balance of payments deficit (3—4)	**689**	**-53**	**-158**	**-162**	**304**	**-174**	**-25**	**551**	**-48**
Private sector	1,055	509	229	233	1,210	336	188	506	180
Public sector	-366	-562	-387	-395	-906	-510	-213	45	-228
6. Short-term capital imports[e]	932	80	-259	382	1,150	305	62	494	289
Private nonfinancial sector	273	-70	-345	-20	533	149	68	199	117
Private financial sector	349	158	73	632	480	280	44	209	-53
Public sector[f]	310	-8	13	-230	137	-124	-50	86	225
7. Capital import surplus (—) or deficit for financing current account deficit (5—6)	**-243**	**-133**	**101**	**-544**	**-846**	**-479**	**-87**	**57**	**-337**
Private sector	433	421	501	-379	197	-93	76	98	116
Public sector	-676	-554	-400	-165	-1,043	-386	-163	-41	-453
8. Change in foreign exchange reserves (increase +, decrease —)	68	124	238	865	419	637	-236	-64	82
9. Errors and omissions (7+8)	-175	-9	343	321	-427	158	-323	-7	-255

[a] The import surplus.

[b] The public sector deficit on goods and services account is defined as follows: direct defense imports, government imports n.e.s., and net interest payments abroad, less port services surplus (excl. fuel) and communication services surplus. The data suggest the existence of another direct public sector import which has not been included here. When the identity of this item is finally clarified the public sector deficit will be increased accordingly and that of the private sector reduced.

[c] Long- and medium-term loans and investments from abroad, less Israeli investments abroad (excluding banks).

[d] Includes allocation of IMF Special Drawing Rights.

[e] Includes various short-term assets.

[f] Includes the Bank of Israel.

Source: Based on Central Bureau of Statistics data.

a slight quantitative drop in imports and exports at the end of 1979 and beginning of 1980.

1. THE CURRENT ACCOUNT DEFICIT[5] AND ITS FINANCING

The year reviewed saw a big increase in the current account deficit, and for the first time since 1975 it was necessary to import short-term capital in order to cover it (see Table III-1). In 1978 too the current deficit swelled, but the public sector was almost solely responsible, owing to a much larger defense import bill. When the growth of the deficit is due to this factor it usually does not present any financing problem, since it is covered as a rule through long-term U.S. government loans, and so its repercussions are felt only in the country's long-term debt burden. In contrast, in 1979 the private sector was responsible for all the increase in the current deficit, as its adverse balance jumped by a resounding $887 million to $1,312 million, while the public sector deficit even shrank. Since the long- and medium-term capital inflow of the private and public sectors was insufficient, there was need, as stated, to resort to short-term capital imports in order to bridge the gap.

An analysis of developments in the course of 1979 shows that most of the deterioration in the basic balance of payments took place quite by chance in the third quarter, when the deficit shot up by $550 million. The underlying factors were at work during the entire year: the foremost cause was the steep rise in the import surplus (see section 2), while on the receipts side (unilateral receipts and long- and medium-term capital imports, less direct defense imports) there was a somewhat stronger nominal growth this year—22 percent vs. 16 percent in 1978.

The widening of the current account deficit, and in particular the worsening of its financing terms, also found expression in a marked growth of foreign currency liabilities, especially those for short terms, which soared by $800 million to $1.8 billion. It should be noted, however, that part of the incremental short-term debt went to enlarge the country's foreign exchange reserves.

The much heavier foreign borrowing, particularly for short periods, and the rise in world interest rates also led to a faster growth of net capital service imports.

	1974	1975	1976	1977	1978	1979
Net capital service imports						
In $ million	231	397	431	416	513	647
As a percent of exports	6.5	10.7	9.7	7.6	7.9	8.4

[5] The import surplus (goods and services), less unilateral transfers.

To conclude, despite the increase in U.S. government aid other than for direct defense imports, there was need to rely also on short-term capital imports for financing the import surplus.[6]

2. CURRENT ACCOUNT

The import surplus (goods and services) continued to grow in 1979, reaching $3,757 million. Since direct defense imports are subject to sharp year-to-year fluctuations which do not reflect economic trends and U.S. financing is related to such imports, we shall analyze the changes in the deficit exclusive of this item. The import surplus so defined rose by $878 million to reach $2.6 billion (see Table III-2). This represented an additional 31.5 percent real expenditure to the economy.[7]

The increase in the import surplus (excluding defense imports) was due entirely to the private sector; the public sector import surplus (excluding defense imports) shrank by $160 million to stand at $230 million in 1979. Unilateral transfer receipts of the private sector rose 16.5 percent in money terms, compared with 12 percent in 1978. It will thus be seen that the level went up only to about the same extent as inflation, and that in both 1978 and 1979 the increase was roughly in line with the decline in the purchasing power of the dollar.

The share of the private sector's import surplus financed by unilateral transfers dropped from 68 percent in 1978 to 45 percent (see Table III-1). Unilateral transfers of the public sector contracted due to a smaller defense import; but even ignoring this component there was a slight downturn, owing to the tapering off of income from the various fund-raising compaigns and a slight drop in U.S. non-military aid grants.

As a result of these developments, the current account deficit of the private sector shot up $890 million, as contrasted with a $360 million decline in the public sector deficit, which was due to a smaller defense import bill and an increase in the sector's civilian surplus.

The following table shows the contribution of price and quantitative changes to the growth of the import surplus (excluding direct defense imports), with a distinction made for the effect of the terms-of-trade change on prices.

It will be seen that close to half of the increase in the import surplus is explained by the grave worsening of Israel's terms of trade, a result of the jump in world oil prices during 1979. This is cause for considerable anxiety, since much of the extra

[6] A glance at Table III-1 (line 5) shows that the basic balance of payments deficit of the private sector grew by $1.2 billion in 1979, while the public sector had a $900 million surplus. The surplus resulted from a $1.1 billion net long- and medium-term capital import (see Table III-1, line 4), of which U.S. government loans accounted for 77 percent.

[7] The nominal rate of increase deflated by the percentage rise in export prices.

	Change in import surplus,[a] in $ million			
	1976-77 (cumulative)	1978	1979	Percentage distribution in 1979
1. Value (2+3)	-710	264	878	100.0
2. Price (a+b)	-79	156	680	77.4
a. Effect of global inflation on export prices	210	213	290	33.0
b. Worsening of terms of trade[b]	-289	-57	390	44.4
Fuel	-12	-112	390	44.4
Other	-277	55	0	0
3. Quantity (at previous year's prices) (1—2)	-631	108	198	22.6
Imports	503	347	553	
Exports	1,134	239	355	
4. Real change in import surplus (2b+3)	-920	51	588	67.0

[a] Excludes direct defense imports.
[b] A minus sign denotes an improvement in the terms of trade.

real expenditure stemming from higher oil prices is probably of a permanent nature as long as the world is experiencing an energy crisis (see Table III-3).[8] Moreover, the extraordinarily high 112 percent increase in oil prices during the year did not show up in the 1979 trade deficit but will find expression only in 1980.

The additional real direct foreign currency outlays due to this factor[9] is estimated to be equal to 8 percent of national income in 1980—roughly the same degree of deterioration that occurred in 1973-74 following the steep rise in basic commodity prices.

The high rates of global inflation during the past two years (excluding the effect of the sharply higher oil prices in 1979) did not detrimentally affect Israel's terms of trade (see the table analyzing the changes in the import surplus); therefore, even though inflation increased the import surplus in money terms, in itself it did not put an additional real burden on the economy. In the financing of the nonfuel import surplus too there was no worsening of Israel's position, since unilateral transfers and long- and medium-term capital imports (excluding defense) outpaced the nominal growth of the nonfuel import surplus. Presumably the accelerated nominal increase in each of the last two years reflected the adjustment of receipts to the mounting global inflation. What is more, the acceleration of global inflation,

[8] For example, in 1973-78 oil prices soared by a cumulative total of 474 percent, while commodity export prices (including diamonds) went up 129 percent.
[9] Without taking into account such indirect factors as the slowing of international commerce and its impact on Israel's exports.

Table III-2

GOODS AND SERVICES ACCOUNT,[a] 1975-79
($ million)

	1975	1977	1978	1979	Percent annual increase: Quantity, Average 1976-77	Quantity, 1978	Quantity, 1979	Price, Average 1976-77	Price, 1978	Price, 1979
1. Imports										
a. Commodities, excl. diamonds and fuel	2,956	2,979	3,693	4,992	-0.5	12.0	16.9	0.9	10.7	15.6
b. Rough diamonds	412	937	1,053	846	39.4	-31.2	-26.5	8.2	63.3	9.3
c. Fuel	638	738	775	1,337	1.6	5.5	6.4	5.9	-0.5	62.1
d. Services[b]	1,853	2,332	2,808	3,392	3.5	9.5	4.5	8.5	10	15.5
e. Administered areas (goods and services)	333	347	354	430	-1	5.5	8.5	3	-3.6	12.3
f. Direct defense imports	1,846	1,099	1,624	1,158	-28.0	40.0	-35.4	7.2	5.5	10.5
Total imports	**8,038**	**8,432**	**10,307**	**12,155**	**-2.4**	**9.3**	**-0.2**	**5.0**	**11.8**	**18.2**
2. Exports										
a. Commodities, excl. diamonds	1,262	1,934	2,367	3,052	20.7	8.4	9.5	2.5	12.9	17.7
b. Diamonds	549	1,003	1,318	1,224	12.0	-16.6	-12.1	20.6	57.6	5.7
c. Services[b]	1,783	2,386	2,815	3,588	9	12.5	11	6	5	15
d. Administered areas (goods and services)	429	551	460	532	9	-10.0	-3.3	4	-7.3	19.6
Total exports	**4,023**	**5,874**	**6,960**	**8,396**	**13.2**	**4.1**	**5.1**	**6.7**	**13.8**	**14.8**
3. Trade deficit, excl. diamonds and fuel (1a—2a)	1,694	1,045	1,326	1,940	-20.0	18.7	30.2	-1.9	6.9	12.4
4. Current surplus on diamonds (2b—1b)	137	66	265	378						

5. Total trade deficit (3+1c—4)	**2,195**	**1,717**	**1,836**	**2,899**	**-8.1**	**6.4**	**18.0**	**-3.8**	**0.5**	**33.8**
6. Deficit on services account	70	-54	-7	-196						
7. Surplus in trade with administered areas (2d—1e)	96	204	106	102						
8. Deficit on goods and services (import surplus)-excl. direct defense imports (5+6—7)	2,169	1,459	1,723	2,601	-15.8	7.4	11.4	-2.6	10.0	35.5
9. Total deficit on goods and services according to balance of payments[c] (8+1f)	**4,015**	**2,558**	**3,347**	**3,759**	**-21.2**	**21.4**	**-11.4**	**1.3**	**7.8**	**26.7**

[a] Based on a c.i.f. recording of commodity imports and f.o.b. recording of commodity exports.

[b] Based on a rough estimate of service prices.

[c] The discrepancies between the figures in this table and those in Table III-1 are due to rounding in this table.

Source: Based on Central Bureau of Statistics data.

and concurrently the price of Israel's exports, reduced the country's real foreign debt.

Despite the world slump in diamonds, Israel's trade surplus on this commodity grew by $113 million in 1979 to total $378 million (see Table XXX-2), since the industry drew on its large stocks of unpolished stones. Excluding oil and diamonds, Israel's trade balance improved by 30 percent, or $400 million, in quantitative terms. This reflected a faster expansion of commodity imports (excluding fuel and diamonds) and a further gain in nondiamond exports at the same quantitative rate as in 1978.

The services account[10] showed a surplus of about $200 million, after it had been roughly in balance the year before. Tourism and "other services"[11] accounted for the better performance in 1979.

The principal factors that influenced imports and exports this year were as follows:

Commodity imports (excluding diamonds and fuel) were quantitatively 17 percent larger this year, after a 12 percent rise in 1978 (this compares with a 5.5 percent gain in the business sector product in each of these two years). In raw materials the increase was 8.5 percent, reflecting the buildup of stocks to the tune of some $170 million, after a $180 million rise the year before. Stocking on such a scale is usual in years when the economy is moving into high gear (or is expected to); during the 1976-77 stagnation stocks were run down by approximately $200 million (at 1979 prices).[12]

Imports of consumer and capital goods were exceptionally large this year, rising 36 and 33 percent respectively in quantity. Consumer goods were paced by durables, a typical feature when the economy is beginning to move out of a slump. Other contributory factors were the real temporary upvaluation of the exchange rate during the second half of the year (the end of 1978 and early 1979), which induced the advancing of purchases; the payment of sizable retroactive salary increases in the public sector; and the unexpected large inflation-generated capital gains. All these stimulated imports of consumer goods at the beginning of the year, but in the final months there were signs of a real downswing.

The greatly increased import of capital goods must also be viewed against the acceleration of economic activity. The aggravation of inflation resulted in a very

[10] Imports of services are calculated on the basis of a c.i.f. recording of commodity imports, and exports of services on an f.o.b. recording of commodity exports.

[11] Such as wages and salaries, management fees, and agents' fees.

[12] These figures are calculated as the difference between actual imports of raw materials (including defense imports not included in the trade account) and imports calculated according to 1972/73 input-output coefficients. They therefore include errors and omissions, and so should be regarded as only an indicator of the change in stocks.

Table III-3

COMMODITY TERMS OF TRADE AND EFFECT OF CHANGES THEREIN ON FOREIGN CURRENCY EXPENDITURE, 1973-79

	1973	1974	1975	1976	1977	1978	1979
1. Terms of trade index[a] (1972=100.0)	96.1	83.0	83.2	86.8	92.5	100.5	93.7
2. Increase in foreign currency expenditure due to changes in terms of trade[b]							
a. In $ million (at current prices)							
Total	106	680	672	532	355	-17	475[c]
Oil price effect	28	435	449	486	508	465	970[c]
b. As a percent of trade deficit							
Total	6.9	28.7	30.6	31.2	20.7	-0.9	16.4
Oil price effect	1.8	18.4	20.5	28.5	29.6	25.3	33.2
3. Terms of trade index, excl. diamonds[a] (1972=100.0)	92.3	83.7	87.2	88.6	88.2	91.8	87.4

[a] The index of export prices divided by the index of import prices. A decline in the index implies a worsening of terms of trade, and an increase implies an improvement.
[b] Base year 1972.
[c] The discrepancy between this datum and that in the import surplus table is due mainly to the fact that here the base year for calculating the terms of trade changes is 1972 while in the other table they are based on the previous year. Another reason is that this table shows the terms of trade for commodities alone, while the other table shows the terms of trade for both commodities and services.
Source: Based on Central Bureau of Statistics data.

hefty subsidization of investment capital, and the public rightly assumed that the authorities would put an end to nonindexed development loans. This apparently led to the advancing of imported equipment purchases, which is the flexible part of the investment plans. The availability of soft loans for renewing the truck fleet, the expectations of a vigorous expansion of activity in the construction industry (which is a heavy user of transport services), and the implementation of large-scale projects in connection with the military redeployment in the Negev contributed to the sharply higher investment in transport equipment.

After quantitative increases of 12 and 15 percent in 1978 and the first half of 1979 respectively, commodity imports (excluding diamonds, fuel, and ships and aircraft) showed a reversal of trend in the third quarter of the year reviewed and fell off sharply in the first quarter of 1980.

The waning of the special factors at work in the first half of 1979, the sharp rise in the price of foreign credit in February 1979, and the freezing of nondirected credit at the end of the year caused imports to taper off and then turn down.

Nondiamond exports forged ahead 8 percent in real terms in 1979, about the same rate as in the previous year and slightly below the longrun trend (see Table

COMMODITY IMPORTS, EXCL. DIAMONDS, FUEL, SHIPS AND AIRCRAFT, 1978-80I

(Percent quarterly changes[a])

	1978				1979				1980
	I	II	III	IV	I	II	III	IV	I
Quantity	0.8	9.6	3.7	-2.4	12.8	1.8	-1.7	-3.2	
Price	5.9	-1.1	4.0	5.7	3.1	3.0	5.6	3.2	
Value	6.8	8.4	7.8	3.2	16.3	4.9	3.8	0.0	-14.1

[a] Original data.

Table III-4

FACTORS EXPLAINING THE GROWTH OF NONDIAMOND EXPORTS, 1975-79

(Percent increase)

	Total exports[a]	Causes of change in exports		Exchange rate	Prices of domestic uses of business sector (at factor cost)
		World trade	Relative price[b]		
1969-78	10.4	7.1	0.6	17.5	25.2
1975-78	9.2	4.4	2.2	40.7	40.6
1975	1.6	-5.0	3.0	41.9	38.1
1976	14.3	12.3	1.8	25.5	26.5
1977	13.0	5.6	5.0	32.1	37.6
1978	8.1[c]	5.5	-1.5 (-0.9)[d]	66.4	62.2
1979	7.8[c]	5.5	0.4 (4.0)[d]	45.5	69.6

[a] At 1970 prices for 1969-75 and at 1975 prices for 1976-77 (based on the national accounts).
[b] The price of exports at the effective rate of exchange in relation to the prices of domestic uses of the business sector (at factor cost). Domestic uses of the business sector are defined as private consumption, public consumption, and investment, less direct defense imports, ships and aircraft, public and nonprofit institution services, imputed residential rents, and net taxes on production. The export data refer to total exports excluding diamonds. This definition differs from that used in Chapter V for calculating the relative price; there additional items are subtracted, resulting in a different relative price from that appearing in this table.
[c] At the previous year's prices.
[d] Includes the directed export credit subsidy.

III-4). The rate of real increase in commodities was similar to that in services; exports to the administered areas fared less well this year.

The expansion of exports was consistent with the rise in their relative price (including the hidden subsidy in directed credit—see Table III-4), as well as with

the 5.5 percent growth of international trade (similar to the gain in the two preceding years). Considering the severance of trade relations with Iran, the export performance (excluding diamonds) was surprisingly good in 1979, although it fell short of what was required in the light of the marked widening of the current account deficit.

The gradual rise in the relative price of exports in 1975-79 (apart from 1978), which was partly due to the calming of domestic demands throughout most of the period, led to the diversion of productive factors (capital and labor) to export production; this was one of the reasons for the sustained advance of foreign sales in 1979.

The hidden subsidy in directed export credit reached significant proportions in the last two years (especially 1979). Nevertheless its impact on the relative profitability of exports is smaller than that of the devaluation of the Israeli pound, since it applies to gross exports and does not take account of the value added component of exports (see the discussion below and in Chapter V).

The leveling off of the relative price of exports (excluding the directed credit subsidy) can be attributed to the real upward revaluation of the Israeli pound at the end of 1978, which was partly related to the sizable short-term capital movements. After the Bank of Israel succeeded in leashing these flows somewhat, the exchange rate of the Israeli pound began to move up rapidly, thereby pulling up the relative price of exports to some extent. It is also likely that it became clear to exporters that the decline in the relative price of exports was only temporary and did not reflect a revision of economic policy, and that in the course of the year the profitability curve would change; hence they did not make any determined effort to alter the export growth trend.

It is nonetheless obvious that this process did not stimulate foreign sales, and the upward revaluation of the Israeli pound gravely harmed a number of export branches, especially agriculture, and heightened uncertainty about exchange rate policy.

To sum up, the main problem confronting exports in the last two years was an insufficient rise in their relative price (in comparison with the price of the business sector's domestic uses—see Table III-4). On the other hand, much of the big increase in domestic demands in the last two years was funneled to imports, so that it had only a slight dampening effect on the export advance. Support for this assumption can be found in the fact that the direct import component of domestic demands rose steeply, while the business sector product moved ahead at a sluggish real pace in relation to the growth of productive factors: the business sector product averaged 5.5 percent higher in 1978-79, compared with 4.5 percent for the labor input and capital stock.

Examination of the development of commodity exports (mainly nondiamond industrial products) over the year shows that the level apparently dipped slightly in the first quarter of the year compared with the average for 1978 (which was fairly steady throughout the year). In the second quarter the curve turned up, accompanied by a rise in the relative price of exports; but it is hard to tell whether this represented a quick response to the relative price change.

NONDIAMOND INDUSTRIAL EXPORTS AND THEIR RELATIVE PRICE,[a] 1978-79
(Indexes: 1977/IV = 100.0; seasonally adjusted data)

	1978				1979			
	I	II	III	IV	I	II	III	IV
Industrial exports	97.5	100.8	95.3	109.6	98.7	112.8	112.0	119.3
Relative price								
Excl. directed credit subsidy	103.9	101.2	103.5	100.6	97.8	98.5	102.1	97.3
Incl. directed credit subsidy	104.6	102.4	106.9	102.4	102.7	105.5	115.3	110.9

[a] The price of industrial exports compared with wholesale prices of industrial output for the domestic market.

The growth of foreign sales at the end of 1979 and early 1980 may also have been influenced to some extent by the cooling of domestic demands, which apparently grew more pronounced at the beginning of 1980.

As to the effect of exchange rate policy on the relative price of imports and exports, it seems that in the last two years in particular (1978-79) the resort to small nominal devaluations of the Israeli pound as a means of bringing about a real devaluation diminished in effectiveness, while the impact of mounting inflation grew sharper.

The rapid inflationary process, which began in 1974 against a background of full employment in the labor market and growing anxieties of employees over the serious erosion of their real wages, strengthened the wage-price link to the extent where wages were fully linked to prices in the last few years. The simultaneous energetic implementation of an exchange rate policy made producers and importers more conscious of the influence of exchange rate fluctuations on commodity prices. It can be said that in the last two years at least there was a very close interplay between import prices, domestic prices, and wages, and this impaired the effectiveness of devaluations and increased their cost to the economy in terms of inflation. Indeed, despite the rapid devaluation during the period March-December 1979, the relative price of exports rose only marginally (if we ignore the subsidy component in directed export credit). This also explains why the Bank of

Israel did not take steps to sharply depress sales of foreign currency to the private sector in the second half of the year. This would have greatly increased the rate of devaluation, which would have found expression primarily in the aggravation of inflation and only to a minor extent in a real devaluation. What is more, because of the almost full indexation of government expenditures and revenue, the basic government liquidity injection probably would have increased correspondingly, thus adding fuel to the inflation.

At this point it would perhaps be worthwhile to return to the question of the present method of subsidizing exports through directed credit. This system is not efficient since it does not take into account the export value-added component. In addition, the exporter cannot be certain about the size of the subsidy he will obtain, and this form of subsidization discriminates between exports and import substitution, even though import substitution, like exports, helps to reduce the import surplus. On the other hand, it must be remembered that Israel still has customs tariffs which descriminate in favor of import substitution. The net effect of these distortions is unknown.

Finally, the existing system hampers the conduct of an effective monetary policy because of the large liquidity injections involved. The direct subsidization of exports also discriminates between exports and import substitution, but the way it was actually implemented failed to efficiently distinguish between the interbranch differences in value added rates.

Despite these distortions one should not conclude that it is recommended to completely forgo the subsidization of exports. In certain circumstances it may be a compelling necessity, such as when there is a very close interrelationship between wages, prices, and the exchange rate.

3. THE CAPITAL ACCOUNT[13]

Net capital imports (excluding defense) rose strongly in 1979 as well, from $800 million the year before to $1.9 billion. This eclipsed the increase in the current deficit, as may be seen from the table below.

	Annual increase in $ million	
	1978	1979
Capital imports[a]	870	1,095
Long-term	230	325
Short-term	640	770
Thereof: Commercial banks	560	-150
Current account deficit	185	780

[a] Long-term loans, net foreign investments in Israel, and short-term capital movements, less defense.

[13] The reference is to long-term loans, net investments from abroad, and short-term capital movements.

Table

CAPITAL MOVEMENTS OF THE FINANCIAL SECTOR
($

	Total foreign exchange reserves of monetary authorities	Non-residents' deposits (1)	Deposits and loans from foreign banks (2)	Liabilities to foreign sector (1+2) (3)	Deposits of local banks abroad (4)
					Balances at end
1975	1,289	1,297	1,391	2,688	1,225
1977	1,770	1,575	2,069	3,644	2,053
1978	2,783	2,365	2,899	5,264	2,877
1979	3,235	3,312	3,287	6,599	3,399
					Changes due to
1977	238	173	424	597	613
1978	865	675	651	1,326	762
1979	419	924	504	1,428	496
1978 IV	660	243	780	1,023	577
1979 I	637	304	-172	132	-128
II	-236	283	203	486	387
III	-64	118	-68	50	-247
IV	82	219	541	760	484

III-5

(COMMERCIAL BANKS), 1975-79
million)

Net liquid liabilities of local banks to foreign sector (5)	Bank credit to nonresidents (6)	Bank purchases of securities (7)	Total net short-term capital movement of financial sector[a] (5-6-7) (8)
of year[b]			
1,463			
1,591			
2,387			
3,200			
economic transactions[c]			
-16	-93	4	73
564	-110	42	632
932	365	87	480
446	25	8	413
260	-26	6	280
99	17	38	44
297	68	20	209
276	306	23	-53

[a] Equals line 6b in Table III-1.
[b] Includes liabilities arising from changes in the value of foreign currencies against the dollar.
[c] I.e. net of the effect of changes in the value of foreign currencies against the dollar.

The expansion encompassed both long- and short-term capital, with the weight of the former in the total increment edging up slightly. The larger long-term inflow in 1979 (in contrast to the previous year's trend) was accounted for by the public sector, which obtained U.S. government loans, while in the private sector the level turned down (see the analysis in Chapter VI). Short-term capital imports continued to rise steadily throughout the year, but underwent a drastic change in composition. In the previous year 87 percent of the incremental short-term capital import was accounted for by commercial banks, which raised an unprecedented volume of credit abroad; in 1979, on the other hand, the private nonfinancial sector was responsible for all the additional short-term capital inflow. The latter development (see Table III-1) was connected with the change that occurred in the basic balance of payments—from a surplus to a deficit, owing to the approximately $1 billion growth of the private sector's basic deficit. In contrast, the decline in the banks' capital import from the second quarter of 1979 is explained by the imposition of a 12 percent interest surcharge on foreign currency credit in February 1979. The Bank of Israel did this in order to staunch the inflow of foreign capital (most of which, as stated, was raised by commercial banks) following the introduction of a stringent monetary policy in the second half of 1978 and because of the rising return on domestic assets (including local currency credit). A capital import of such large dimensions might have had negative repercussions, both on the movement of the exchange rate and on the economy's liquidity; hence the measures taken by the Bank of Israel.

In examining developments in the course of the year it is hard to accurately pinpoint the downturn in foreign credit mobilization by the banks, since account must be taken of the seasonal increase in the banks' capital movements at the end of the year before publication of their balance sheets and the offsetting drop in the first quarter of the following year. However, the data for 1979 show that the short-term capital import of the financial sector began to shrink after the Bank of Israel's action. The banks' gross capital flows were still quite substantial this year, as evidenced by their foreign liabilities, which were up $1.4 billion, compared with a $1.3 billion rise in 1978 (see Table III-5). At the same time there was a precipitate increase in the banks' overseas assets (deposits of local banks abroad) and loans granted to foreign nationals. This reflected the continued greater integration of the financial system with foreign money markets, a trend that set in with the liberalization of foreign currency control.