

CHAPTER V

DOMESTIC INVESTMENT

1. MAIN DEVELOPMENTS

GROSS DOMESTIC capital formation expanded at an unprecedented rate in 1968—by 44 percent at constant prices as compared with 1967. In absolute terms, the increment came to about IL 900 million at 1968 prices, bringing the total figure up to approximately IL 2,900 million. However, this was still below the peak 1964–65 level of some IL 3,300 million (at 1968 prices). The difference stemmed entirely from the smaller investment in residential construction, whereas fixed nondwelling investment was close to its 1965 level.

Investment demand began to rise in the second half of 1967, and it continued upward at a steady pace throughout the year reviewed. The growth was influenced by the general expansion of demand in the economy: a rise in profitability, the expansion of immigration and tourism from abroad, the huge defense requirements, and the initiation of large public projects.

The sharp rise in capital formation in 1968, like the contraction of previous years, was reflected by relatively small changes in the growth of the economy's capital stock. The gross stock of capital assets increased by 8 percent in 1968 in real terms, compared with only 5 percent in 1967 and an average of some 11 percent per annum in 1960–65. Outstanding increases were recorded in industry and construction, where the figure went up 8 percent as against only 2 percent in the two preceding years.

Another factor contributing to the strong growth of capital formation in 1968 was the existence of a reserve of idle capital and manpower, which could be diverted to construction and to the production of other capital assets. In addition, there were on hand investment plans which had been prepared during the period of economic slowdown and even before, but whose execution had been postponed. But most of the buoyant investment demand was supplied from imported plant, equipment, and transport vehicles, which doubled in volume in 1968. This substantial increase in the weight of imports eased the pressure on domestic production, but at the same time it was largely responsible for the big growth in the country's import bill and in the balance of payments deficit on current account.

The expansion of capital formation was accompanied by some structural changes. The proportion invested in industry, construction, and transportation

Table V-1

GROSS AND NET INVESTMENT, 1964-68

(IL million, at current prices)

	1964	1965	1966	1967	1968	Percent real change from previous year			
						1965	1966	1967	1968
Gross fixed nondwelling investment	1,881	1,957	1,700	1,458	2,159	—	-15	-15	30
Less: Depreciation	637	741	832	898	993	12	10	6	3
Net fixed nondwelling investment	1,244	1,216	868	560	1,166	-7	-30	-36	99
Gross investment in dwellings	868	977	787	532	612	7	-19	-32	8
Less: Depreciation	216	249	273	292	324	10	9	7	4
Net investment in dwellings	652	728	514	240	288	6	-29	-53	13
Total gross fixed investment	2,749	2,934	2,487	1,990	2,771	2	-16	-21	31
Change in inventories	182	86	110	-66	174				
Total gross investment	2,931	3,020	2,597	1,924	2,945	-1	-15	-26	44
Less: Depreciation	853	990	1,105	1,190	1,317	12	10	6	4
Total net investment	2,078	2,030	1,492	734	1,628	-7	-27	-51	110

SOURCE: Central Bureau of Statistics and Bank of Israel.

and communications rose, while that in agriculture, irrigation, and the commerce and service sectors declined somewhat. There was a sharp fall in residential construction put in place, which was only about half as large as in the peak year (1965). This is explained primarily by the small area of building starts in the two preceding years, which depressed the volume of completions in 1968, and also by the existence of a large stock of unsold dwellings in public housing projects.

These developments produced two conspicuous changes in the structure of investment in 1968: the relative share of equipment in the total increased from 34 to 41 percent, and within total outlay on equipment the percentage of imports rose.

Inventories expanded by IL 175 million, after contracting by some IL 65 million in 1967. The 1968 increment was of similar proportions to that of the previous boom period.

Fixed nondwelling capital formation in 1968 breaks down equally between the public sector (including public sector companies) and the private sector (exclusive of nonprofit institutions). This is after an increase of 70 percent in private investment and 22 percent only in that of the public sector and its companies.

Public financing of fixed nondwelling investments of the private sector and of public sector companies was on a larger scale in the year reviewed. The sum total of such financing, which includes purchases of shares, grants, and loans from the development budgets of the Government and the National Institutions, expanded by some 47 percent. The financing of private investment from internal sources apparently was also much higher in 1968.¹

2. QUARTERLY DEVELOPMENTS

Fixed capital formation has expanded steadily since the third quarter of 1967. Total expenditure on fixed assets other than ships and aircraft in the last quarter of 1968 was about 40 percent larger than at the onset of the economic recovery, reaching the average level for 1964 (see Table V-2 and Diagram V-1).

The level undoubtedly dipped to its lowest point in the second quarter of 1967, which was overshadowed by the war and the preceding period of tension. This factor accentuated the downward movement discernible from the beginning of 1966, but on the other hand it had an important bearing, both directly and indirectly, on the reversal of the trend and its subsequent rapid rise.

Most of the expansion took place in new plant, equipment, and transport vehicles, which advanced approximately 80 percent from the middle of 1967

¹ This consists chiefly of undistributed profits and depreciation allowances.

Table V-2

GROSS FIXED INVESTMENT,* QUARTERLY, 1964-68

(Quantitative indexes: quarterly average for 1967=100)

	Quarter	Total fixed investment, excl. ships and aircraft	Housing	Other construction	Plant, equipment, and transport vehicles
1964	I	139	164	113	153
	II	139	168	111	149
	III	145	175	122	151
	IV	146	179	131	136
1965	I	155	197	133	147
	II	145	187	115	157
	III	150	177	129	155
	IV	149	174	124	159
1966	I	151	168	127	170
	II	127	157	107	126
	III	120	139	106	121
	IV	113	128	107	106
1967	I	107	115	104	105
	II	81	77	81	86
	III	102	104	99	103
	IV	110	104	116	106
1968	I	118	102	109	145
	II	122	111	108	152
	III	134	112	125	167
	IV	142	109	136	180

* Excluding ships and aircraft.

SOURCE: Central Bureau of Statistics.

to the end of 1968. Purchases of these items reached a new high in the last quarter of 1968, with imported plant and equipment accounting for the lion's share of the growth. Especially big rises were recorded in imported industrial and construction equipment, which quadrupled between the third quarter of 1967 and the last quarter of 1968. Nonresidential construction at the end of 1968 exceeded the peak level of the beginning of 1965. On the other hand, investment in housing moved up at a sluggish pace, fluctuating mildly from quarter to quarter.¹

The various factors influencing the quarterly development of the different types of investment mentioned here are discussed in greater detail below.

3. INVESTMENT, BY TYPE OF INVESTOR

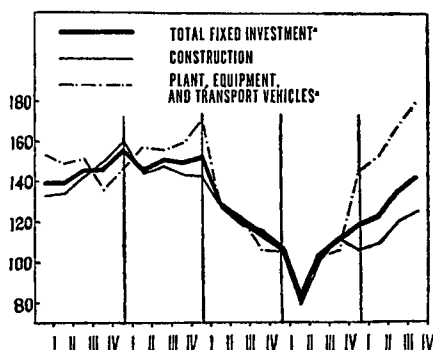
Both the public and private sectors contributed to the strong growth of capital formation in 1968, but the rise in private investment was more rapid (see Table V-3). The latter displays sharper fluctuations during boom and slump periods than does public sector investment. This is easily understood, since capital expenditure by the public sector is by its very nature less affected by such factors as the expansion of aggregate domestic demand, increased profitability, or future expectations. The rise of approximately 22 percent in fixed nondwelling investment by the public sector, following a decline to a similar extent during the two preceding years, chiefly reflects the fluctuations in capital spending by public sector companies. Their investment activities are affected both by current economic developments (in which respect they resemble private concerns) and by Government security, economic, and political decisions.

Much of the public sector's capital outlay between the middle of 1967 and the end of 1968 represented new investments attributable to special developments during this period. To begin with, stronger domestic demand on the part of the defense establishment, connected with the tendency to expand Israel's production capacity in this sphere, led to large-scale investments in the military industry, the

Diagram V-1

GROSS FIXED INVESTMENT,* QUARTERLY, 1964-68

(Quantitative indexes; quarterly average
for 1967=100)



* Excluding ships and aircraft.

¹ Owing to the low reliability of the quarterly estimates, these slight fluctuations may have been due to statistical deficiencies, and hence any conclusions that are not based on significant changes should be treated with reserve.

Table V-3

GROSS FIXED INVESTMENT, BY TYPE OF INVESTOR AND INITIATING SECTOR, 1964-68

(IL million, at 1968 prices)

	1964	1965	1966	1967	1968	Percent increase or decrease (-) as against preceding year			
						1965	1966	1967	1968
Nondwelling investment, by investing sector ^a									
Government, local authorities, and National Institutions	315	363	332	384	411	15	-9	16	7
Government enterprises ^b	198	232	225	183	183	17	-3	-19	—
Public sector companies ^c	504	346	298	254	408	-31	-14	-15	61
Total public sector investment	1,017	941	855	821	1,002	-7	-9	-4	22
Nonprofit institutions	142	138	153	142	145	-3	11	-7	2
Private business enterprises ^d	990	1,060	816	584	1,011	7	-23	-28	73
Total private sector investment	1,132	1,198	969	726	1,156	6	-19	-25	59
Total nondwelling investment	2,149	2,139	1,824	1,547	2,158	—	-15	-15	39
Investment in dwellings, by initiating sector									
Public	353	369	275	162	156	5	-25	-41	-4
Private	614	667	561	404	456	9	-16	-28	13

^a There is a conceptual difference between public sector investment and the sector's purchases on capital account.^b The trading enterprises of the public sector, including the Post Office, Israel Railways, air and sea ports, and local authority enterprises.^c Companies in whose management the public sector has the decisive voice.^d Calculated as a residual.

SOURCE: 1964-65—Central Bureau of Statistics, with the data adjusted for differences in definitions; 1966-68—Bank of Israel estimates.

aircraft industry, and other public companies capable of manufacturing import substitutes for security purposes. Under the same head fall the investments in the new oil pipeline from Eilat to Ashkelon, the construction of public shelters, and the building of security roads.

At the same time, projects shelved from previous years were implemented at full speed in 1968. These public investment projects were intended to give a fillip to economic activity and employment during the recession, but were actually implemented only at the end of 1967 and in 1968. These projects included the erection of Government and other public buildings, roadbuilding, the further development of postal and telecommunication services, and the start of work on the chemical complex in Arad. The development work carried out in all three Israeli ports should perhaps be added to the list.

Fixed nondwelling investment by the private sector (excluding nonprofit institutions) expanded by some 70 percent in 1968, after contracting by 23 and 28 percent in the two preceding years. The level of investment largely depends on investors' expectations concerning future profits. These expectations have been affected by the growth of demand in the economy since the middle of 1967, which has been accompanied by advancing output and sales figures. Of particular significance is the substantial growth of profits over the last two years, which reflects the relative stability of input prices and wages during this period, coupled with a rise in productivity. A good indicator of profitability is the return per unit of capital¹ in the private sector (including public sector companies). The return doubled between 1966 (when it was at its lowest) and 1967, and doubled again between 1967 and 1968, thus regaining its prerecession level of 1964-65.

The amendments to the Law for the Encouragement of Capital Investments, passed by the Knesset at the beginning of 1967, contributed to the expectations of a rising trend. The main concession to investors in approved enterprises is the payment of a grant amounting from 10 to 33 percent of the value of the investment, depending on the type and location.² In 1968, IL 28 million in grants were paid on investments actually executed, as compared with some IL 5 million the year before. About half the grants went to the textile industry (for the establishment of new enterprises), and most of the remainder to the chemical, metal, machinery, wood, and printing industries. Geographically, approximately three-quarters of the grants were given to enterprises in development areas.

The brisk public sector demand for goods and services for security purposes has given a further strong impetus to private investment. The defense establishment is placing an increasing share of its procurement orders with local private concerns, even for items which were formerly imported. Their production requires new investments, especially in plant and equipment.

¹ Defined here as the ratio between the net return to capital, less imputed wages of self-employed, and the net fixed nondwelling stock (excluding that of the public services).

² For additional details and explanations, see Bank of Israel, *Annual Report 1967*, p. 109.

A number of exogenous factors also influenced the private sector's non-dwelling investment demand. Immigration and tourism to Israel rose in 1968, exerting a stimulative effect. On the other hand, certain other factors, of lesser importance, operated in the opposite direction. Capital transfers of nonprofit institutions from abroad, which normally are used for financing investments, were slightly smaller than in 1967. Other capital transfers for investment purposes (the "net investments from abroad" item in the balance of payments)¹ remained at their low 1967 level of some \$ 25 million. Capital transfers of nonresidents have been moving steadily downward since 1964, while the repatriation of foreign investments has been rising.

The various factors mentioned above found expression in private sector investment in industry, in the purchase of machinery and equipment for the construction sector, in the erection of hotels, in the acquisition of transportation equipment, and in the sizable expansion of the merchant fleet. This was the first year in which the entire investment in shipping, totalling some IL 100 million, was made by private companies.

The demand for investment in dwellings, both publicly and privately initiated, was influenced in 1968 by the growth of immigration, which in the two preceding years had fallen to a low level. The increase in immigration was accompanied by a structural change, the proportion of newcomers from affluent countries rising. Part of the additional demand for housing in 1968 was supplied from the stock of unsold units accumulated in 1966 and 1967. It should also be noted that the Ministry of Housing purchased a large number of units from the private sector during the year, and turned them over to new immigrants.

4. INVESTMENT, BY ECONOMIC SECTOR

In most sectors fixed nondwelling investment in 1968 almost reached the record level of 1965. The expansion during the year reviewed was more or less equal to the contraction that occurred in 1966 and 1967 together. These fluctuations are clearly shown in Table V-4.

Investment in housing, on the other hand, was still far smaller than in 1965. Consequently, the weight of this item in domestic capital formation decreased from an annual average of some 32 percent in 1960-66 and 27 percent in 1967 to 22 percent in 1968. The small outlay on residential construction in the last two years resulted in demand exceeding supply in 1968, so that dwelling prices rose. The lag in the recovery of this branch is apparently only of a temporary nature, being due chiefly to the small area of starts in previous years, which was reflected by a small volume of completions in 1968. Another reason is the need to revise architectural and engineering planning following the change in the structure of immigration and the shifting of the main foci of demand to new

¹ See also Table III-23 in Chapter III, "The Balance of Payments".

areas, such as Jerusalem. The large stock of empty dwellings available at the beginning of 1968 was sold in the course of the year, filling part of the gap between supply and demand.¹

Table V-4
CHANGES IN FIXED INVESTMENT, BY SECTOR, 1965-68
(IL million, at 1968 prices)

	From 1965 to 1967	From 1967 to 1968
Total fixed investment	-1,063	658
Agriculture	-13	-5
Irrigation	-8	-11
Industry	-178	218
Construction	-64	54
Electric power	-34	28
Transportation and communications	-210	218
Commerce and services	-86	110
Total fixed nondwelling investment	-593	612
Dwelling investment	-470	46

In a sectoral analysis of nondwelling investment two main groups can be distinguished: (1) sectors where investment was not seriously affected by the economic slowdown, such as agriculture, irrigation, electric power, and public services (e.g. education and health); and (2) sectors where capital expenditure was cut back sharply during the recession and subsequently expanded rapidly, such as industry, construction, part of the transportation and communications sector, and personal services.

Investment in agriculture and irrigation has been on the decline for several years. As regards irrigation, the downtrend began in 1964, after completion of most of the work on the National Water Carrier. In agriculture, the contraction has been in evidence for about 10 years. This is generally attributed to the disproportion between the growth of demand and the expansion of supply. In 1968 the continued decline in investment in orchards should be noted, as well as the smaller expenditure on afforestation as compared with the previous year, which was reflected by a drop in the number of persons working on unemployment relief projects. On the other hand, outlay on farm machinery and equipment (including tractors) was up some 25 percent.²

Industrial investment, which was cut back most sharply during the recession,

¹ See also Chapter XIII, "Construction and Housing", section 3.

² See also Chapter XI, "Agriculture", section 5.

Table V-5

GROSS FIXED INVESTMENT, BY ECONOMIC SECTOR AND TYPE OF ASSET, 1960-68

(IL million, at 1968 prices)

	1960	1961	1962	1963	1964	1965	1966	1967			1968		
								Build-ings	Equip-ment	Total	Build-ings	Equip-ment	Total
Agriculture	226	213	200	178	195	181	158	100	68	168	90	73	163
Thereof agricultural output	108	99	100	86	91	81	65	65	13	78	55	5	60
Irrigation	88	103	142	152	107	79	75	62	9	71	49	11	60
Industry, mining, quarrying	345	419	359	429	465	426	320	82	166	248	115	351	466
Construction (equipment)			72	65	67	72	25	—	8	8	—	62	62
Electric power	70	78	97	70	63	106	112	34	38	72	43	57	100
Transportation and communications	276	401	351	391	697	651	515	203	238	441	276	383	659
Ships and aircraft	127	195	75	59	206	108	55	—	53	53	—	119	119
Transport equipment	58	90	119	159	202	196	144	—	86	86	—	164	164
Other items	91	116	157	173	289	347	316	203	99	302	276	100	376
Commerce and services	334	384	398	470	555	625	619	381	158	539	449	200	649
Housing	572	698	878	872	967	1,036	836	566	—	566	612	—	612
Total fixed investment	1,911	2,296	2,497	2,627	3,116	3,176	2,660	1,428	685	2,113	1,634	1,137	2,771

SOURCE: Central Bureau of Statistics.

expanded by an impressive 90 percent approximately in 1968 to regain its level of 1964–65. The biggest increases were in the textile, chemical, oil refining, metal, and metal products branches. Imports of machinery and equipment for these branches more than tripled in 1968. The defense establishment was a major factor in the demand for industrial investment in 1968 (the reference is to the military industry, other concerns belonging to the defense establishment, and enterprises connected with it as suppliers). But it should be pointed out that the expansion of investment affected almost all branches of industry, testifying to the influence of the general growth factors already mentioned, side by side with the specific factors affecting individual branches.

Expenditure on machinery and equipment for the construction sector fluctuates sharply from year to year, according as the sector's output changes. The downward trend in such investments began in 1966, but since the second quarter of 1968 they have been expanding rapidly. Investment in equipment responded to the revival of construction demand after a lag of six to nine months. In 1967, the second year of the slump, a mere IL 7 million was spent on equipment despite the upswing in building activity toward year's end. On the other hand, it should be stressed that the further mechanization of the sector had an immediate effect on its production capacity. The equipment purchases in 1968 increased the sector's output during the same year, especially as regards earthwork.

Capital spending in the electricity and transportation and communications sectors is mainly on big projects directly or indirectly associated with Government decisions. Most of the incremental investment in 1968 was for the erection of the Reading "D" power station in Tel Aviv, the laying of the new oil pipeline, and large-scale construction work at the three ports—Haifa, Ashdod, and Eilat. Investment in posts and roads remained at its high 1967 level. The much larger purchase of trucks and other commercial vehicles is striking evidence of the buoyant state of the economy in the year reviewed.

The rapid growth of the merchant fleet was expressed primarily in the acquisition of refrigerator ships and bulk carriers. Many of the new ships are not used for hauling cargoes to and from Israel, but ply between foreign ports.¹

The commerce and services sector also displayed disparate growth rates. Investment in public services, such as education and health, continued upward at a moderate pace, even during the recessionary period. In commerce there were no significant changes, and expenditure on the construction of business premises increased only very slightly. This relative stability is explained by the large stock of business premises standing empty throughout most of 1968. On the other hand, investments connected with tourism—both foreign and domestic—expanded appreciably. In 1968 the number of foreign tourists visiting Israel was some 50 percent larger than in 1967, and the average amount spent per tourist was also higher. In view of the predicted continued rising trend in tourism and

¹ See also Chapter XIV, "Transportation and Communications".

Table V-6
REAL CHANGE^a IN GROSS FIXED INVESTMENT, BY SECTOR, 1961-68
 (percentages)

	1961	1962	1963	1964	1965	1966	1967	1968
Agriculture	-6	-6	-11	9	-7	-13	6	-3
Irrigation	16	38	7	-30	-26	-5	-6	-15
Industry, mining, and quarrying	} 22	3	20	8	-8	-25	-22	88
Construction (equipment)			-11	4	6	-65	-70	709
Electric power			-28	-10	67	6	-36	39
Transportation and communications	46	-13	11	78	-7	-21	-14	49
Commerce and services	15	4	18	18	13	-1	-13	20
Housing	22	26	-1	11	7	-19	-32	8
Total fixed non- dwelling investment	19	1	8	22	—	-15	-15	39
Total investment, excl. dwellings, ships, and aircraft	16	10	10	15	5	-13	-15	36

^a At 1968 prices.

the much higher hotel occupancy ratio in 1968, the growing investment in hotels is easily understood. Moreover, there is no doubt that investments in allied service establishments are also rising steeply. This applies particularly to restaurants, coffee houses, travel facilities, development of historic sites, etc.

5. INVESTMENT, BY TYPE OF ASSET

There were two striking changes in the structure of investment in 1968: First, the weight of equipment (including mobile transport equipment) in total investment rose appreciably—from an average of some 34 percent in recent years to 41 percent. Second, there was a real decrease in the share of machinery and equipment manufactured in Israel and a rise in the proportion of imports (see Table V-7).

These changes were mainly due to the altered sectoral composition of investment demand. In 1968 the biggest increases were recorded in industry and construction, where the weight of equipment within total investment is relatively large, and the proportion of imported equipment within total equipment is high. But there was a similar development in all other economic sectors, which can be attributed to limitations on the supply side, as explained below.

The strong growth of demand for fixed assets, which began at the end of 1967, could not be satisfied immediately. The most protracted process, from the

technical aspect, is usually that connected with the erection of buildings and other structures.¹ Consequently, such investments cannot be expanded in line with the growth of demand, even if there are no constraints as regards factors of production. In actual fact, difficulties were apparently experienced in obtaining skilled building workers in certain areas, and this was another factor impeding the execution of such investments. The shortage of heavy mechanical equipment likewise held up the implementation of earthwork, especially in the first months of 1968.

While domestic production of machinery, equipment, and vehicles increased by as much as 26 percent, it should be remembered that Israeli industry is still unable to supply most of the orders for special intricate machinery and equipment. That local industry was able to satisfy a substantial part of the heavy investment demand can be ascribed to the existence of unexploited production capacity (capital and labor) in the metal, machinery, electrical appliances, and automotive vehicle branches. In these four branches, domestic output of capital goods expanded by 50–70 percent—rates far above the average.

Imports of plant and equipment usually react very quickly to sharp fluctuations in investment demand. In 1966, with the onset of the economic slowdown, imports of investment goods declined more steeply than total domestic investment. In 1968 imports of investment goods soared 97 percent, whereas total fixed nondwelling investment increased by 39 percent. A rough estimate shows that a large percentage of the imported plant and equipment in 1968 went to existing enterprises. These may have been partly intended to replace worn-out machinery and equipment, the scrapping of which had been shelved during the two previous years. Part of the imports were intended for enterprises expanding production or switching to new production lines (e.g. synthetic products in the textile industry). At any rate, the import of plant and equipment is not dependent on the completion of the numerous buildings now under construction. In this context, it should be emphasized that the life of a building is normally about double that of plant and equipment.

Because of the continuing pressure of demand for imported investment goods, it cannot be ascertained whether the relative increase in the cost of imported equipment after the devaluation of 1967 had any significant effect. However, it should be noted that, compared with the previous devaluation of 1962, the change in the effective exchange rate relative to the rise (of some 2 percent) in the prices of locally produced items was very small.

¹ The average construction time varies in accordance with the type of building, its size, and location. A residential building usually takes between one and two years to erect. The gestation period of industrial investments, defined as the time elapsing between the start of detailed planning and physical completion of the enterprise, is estimated to average some 26 months in the case of new plants and 23 months for the expansion of existing concerns. The interbranch range is from 19 to 42 months (according to preliminary findings of a survey carried out by the Ministry of Commerce and Industry).

Table V-7

**SHARE OF TOTAL OUTLAY^a ON CAPITAL GOODS^b SUPPLIED FROM LOCAL
PRODUCTION, BY SECTOR OF DESTINATION, 1964-68**

(percentages)

	Share of goods undergoing some processing in Israel ^c					Total domestic product component ^d				
	1964	1965	1966	1967	1968	1964	1965	1966	1967	1968
Agriculture	58	57	60	65	58	46	46	48	51	50
Industry, electric power, water, and construction	30	29	31	37	23	35	35	39	42	34
Transportation and communications ^e	46	49	56	49	47	56	54	57	57	58
Commerce and services	53	58	54	56	56	56	58	56	55	54
Total	34	39	43	44	35	40	42	47	47	40
Total, excl. ships and aircraft	42	43	46	48	39	48	47	50	51	45

^a At constant 1967 prices.

^b Machinery, equipment, and transport equipment.

^c According to their value to the investor.

^d That is, less the import component of the capital goods undergoing some processing in Israel, plus the domestic value added derived from the marketing, transporting, and installation of imported equipment, as well as taxes thereon. The data are based on constant input-output coefficients calculated in various Bank of Israel studies and partly updated for the years 1963-65.

^e Exclusive of imported ships and aircraft.

SOURCE: Central Bureau of Statistics and Bank of Israel.

The changes in the weight of local production within total expenditure on investment assets over the past five years are set forth in Table V-7. The most notable changes occurred in the "industry, electric power, and construction equipment" group. The weight of domestic production rose considerably in 1966-67, the period of economic slowdown. This is true whether domestic production is defined as the total value of capital goods undergoing some processing in Israel, or whether it is defined more narrowly as the value-added component (including taxes and the cost of marketing, transporting, and installing imported equipment). The decline in investment demand during the recessionary period hit imports—or the total import component—more than it did local production. This can perhaps be explained by the deferment of investments in big projects requiring special equipment from abroad, whereas the demand for tools and standard equipment produced in Israel contracted to a lesser extent.

Because of the sharp fluctuations in the share of domestic production in recent years, it is impossible to judge whether there is a rising trend in the local manufacture of capital goods. It can only be stated that 45–50 percent of the total outlay on new plant, equipment, and vehicles in recent years represented value added (and taxes). This figure, as already pointed out, also includes the cost of marketing, transporting, and installing imported equipment, so that the expansion of machinery and equipment imports was accompanied by an increased demand for the local factors of production required for their absorption.

6. PRICES

After holding steady for two years, investment prices moved up by an estimated 7 percent in 1968. This big increase, relative to the prices of other domestic uses, partly reflects the excess investment demand prevailing during the year reviewed in most sectors of the economy, and partly the effects of the devaluation of November 1967.

Whereas most of the heavy demand for machinery and equipment was met by doubling the import of these assets, the additional demand for construction could not be satisfied in a similar manner. Here supply lagged behind demand owing to the technical reasons already mentioned, and apparently also because of the growing difficulties experienced in obtaining certain types of construction equipment as well as skilled labor in certain areas of the country. The existing stock of vacant buildings in many cases did not meet investors' requirements as regards location, type of premises, or quality. Owing to this development, construction prices averaged some 6 percent higher in 1968. Materials and services cost about 4.5 percent more, with most of the increase being due to the higher prices of imported inputs after the devaluation. As to labor costs, this component is measured by the changes in the official wage rates, which do not reflect the actual payroll expenditure. Information from various sources points to a rise in the wages of skilled construction workers and operators of mechanical equipment. At the same time, however, the proportion of building workers from East Jerusalem and the administered areas, whose wages are comparatively low, increased. Contractors' profits were apparently much larger in 1968, as may be inferred from the advance of some 27 percent in the sector's output¹ compared with only 14 percent in its total payroll outlay.

A further indicator of the rise in construction costs is provided by the index of housing prices, which shows an estimated increase of 7 to 8 percent between

¹ Assuming that the product originating in this sector expanded to at least the same extent. The difference between the product and the wage bill includes, in addition to contractors' profits, interest paid. Since interest outlay apparently did not increase in 1968 much faster than total output, the conclusion concerning profits stands. See also Chapter XIII, "Construction and Housing".

1967 and 1968¹ for dwellings put up by private contractors. This relatively steep rise testifies to the existence of demand pressure in the housing market in the year reviewed.

The approximately 8 percent higher cost of machinery and equipment can be directly attributed to the devaluation. The total increase in the price of imported equipment in 1968 came to some 10 percent, after allowing for the cuts in customs duty rates and the slower rise in the cost of installing and marketing imported equipment. The higher cost of the import component of locally manufactured equipment led to the raising of its prices by some 2 percent on an average.

At the same time, there was a factor exerting a dampening effect on the cost of certain items of equipment to the investor in 1968, though this was not reflected in the implicit price index. The reference is to the grants paid on approved investments under the Law for the Encouragement of Capital Investments, and which amounted to between 20 and 33 percent of the value of the equipment. These rates are much higher than in the case of investments in construction, which ranged from 10 to 20 percent.

7. CAPITAL STOCK

The gross nondwelling capital stock expanded by approximately 8 percent in real terms in 1968. This was higher than the 5 percent rise registered in 1967, but below the average annual increase of approximately 11 percent in 1960–65. It should be noted that economic growth² averaged some 10.5 percent per annum in 1960–65, fell to 2 percent in the next two years, and jumped to 13 percent in 1968. A 7–8 percent average annual increase in the capital stock in the next several years would presumably correspond, more or less, to a somewhat lower rate of economic growth than that of the previous boom period.

In 1968 there was an outstanding rise of some 8 percent in the stock of capital assets in the industrial and construction sectors, as compared with approximately 2 percent only in the two preceding years. This change checked the decline in the weight of these sectors within the economy's total capital stock, which fell from 26 percent at the end of 1959 to 23 percent at the beginning of 1969 (see Table V-8). The stock of fixed assets in the transportation and communica-

¹ The index of housing prices also includes the prices of secondhand dwellings, as well as the imputed changes in the value of the land on which the building is standing (which is not included in the investment). But despite these and certain other reservations concerning the accuracy of the measurement (see also Chapter VI, "Prices"), it indicates the order of magnitude of the changes in construction investment prices in 1968. In view of the estimated direction of the bias of this index, it should be regarded as showing the lower limit of the prices concerned.

² The real change in the gross national product.

Table V-8
GROSS CAPITAL STOCK, BY SECTOR, 1968

(IL million, at 1968 prices)

	Capital stock at beginning of 1968	Gross investment in 1968	Discards in 1968	Incremental capital stock in 1968	Capital stock at end of 1968	Weight in total capital stock (end of year)		Weight in incremental capital stock in 1968
						1959	1968	
Agriculture	3,564	163	79	84	3,648	22	15	5
Irrigation	1,722	61	5	56	1,778	9	8	3
Industry and construction ^a	4,951	528	141	387	5,338	26	23	22
Electric power	1,401	99	21	78	1,479	7	6	5
Transportation and communications	4,850	659	85	574	5,424	18	23	33
Commerce and services	5,302	649	101	548	5,850	18	25	32
Total nondwelling capital stock	21,790	2,159	432	1,727	23,517	100	100	100
Dwellings	12,973	612	12	600	13,573			
Total stock of fixed assets	34,763	2,771	444	2,327	37,090			

^a Includes industry, mining, quarrying, and construction equipment.

SOURCE: Based on estimates of A. L. Gaathon. For definitions and explanations, see A. L. Gaathon, *Capital Stock, Employment and Output in Israel, 1950-1959*, Bank of Israel, Jerusalem (1961), p. 2.

tions sector and of the commerce and services sector continued to grow at an above-average rate, and these two sectors accounted for almost half of the total nondwelling capital stock at the end of 1968.

It should be noted that the gross capital stock reflects both gross investment and the value of scrapped assets,¹ which represents the value of the assets that have been withdrawn from use because of obsolescence. In agriculture and industry, the proportion of discards is very high; in other words, a considerable percentage of the total annual investment in these sectors is intended to replace discarded assets. Consequently, a larger increase in gross investment is required in these sectors than elsewhere if they are to maintain their relative shares of the total capital stock.

Table V-9
GROWTH OF REAL CAPITAL STOCK, BY SECTOR, 1960-68
(percentages)

	Agri- culture	Irri- gation	In- dustry and con- struc- tion	Elec- tric power	Trans- porta- tion and commu- nications	Com- merce and serv- ices	Total non- dwell- ing capital stock	Dwel- lings	Total fixed assets
Average, 1960-65	5	9	9	8	15	16	11	10	10
1966	3	5	3	8	9	12	7	7	7
1967	3	4	2	5	7	9	5	4	5
1968	2	3	8	6	12	10	8	5	7

To sum up the main changes in the sectoral composition of the economy's capital stock during the past decade, agriculture and industry have displayed a declining trend and transportation and communications and the services a rising trend. This pattern corresponds to the changes that have occurred during this period in the breakdown of the net national product, which also shows an increase in the weight of the two last-mentioned sectors.

The gross capital stock represents the estimated potential production capacity of the economy at a given time, but not the capital actually utilized in production. During the recession, i.e. until the middle of 1967, a large reserve of un-

¹ The value of discards is based on the estimated economic life of various types of assets. The estimate for any given year is of limited significance and indicates orders of magnitude only. For additional reservations and explanations concerning this term and others used here, see A. L. Gaathon, *op. cit.*, Ch. 1.

Table V-10
GROWTH OF REAL CAPITAL STOCK PER GAINFULLY EMPLOYED,^a
BY SECTOR, 1964-68

(percentages)

	Agriculture and irrigation	Industry, water, electricity	Trans- portation and commu- nications	Commerce and services	Total fixed non- dwelling capital stock	Dwelling stock per capita
1964	9.1	2.8	1.8	7.6	4.2	5.5
1965	0.8	4.1	23.9	12.9	8.1	6.3
1966	10.9	9.7	21.6	10.4	10.2	6.7
1967	7.0	16.6	2.4	15.1	12.6	4.8
1968	5.9	-10.6	-0.1	1.6	-3.4	2.3

^a Data on capital stock relate to the beginning of the year, while the number of gainfully employed is an annual average. The capital stock per gainfully employed in a given year is the capital stock at the beginning of that year.

utilized production capacity was accumulated, and this began to be activated when demand in the economy picked up toward the end of that year. In the first half of 1968, most of the previously idle capital stock was apparently being utilized for current production. An examination of the capital/product ratio shows that it went up slightly in 1965 and more rapidly in 1966 and 1967, after holding steady from 1960 to 1964.¹ In 1968 the ratio virtually regained its 1965 level. These changes clearly indicate the existence of unutilized production capacity during the recession period.

In view of the foregoing, the changes in capital stock per gainfully employed, as presented in Table V-10, should be regarded only as of limited significance. The growth in 1967 and the decline in 1968 relate only to the potential capital stock per gainfully employed during these years.

¹ These changes are reflected in the capital/product ratio, whether inclusive or exclusive of dwellings, as may be seen from the following data:

	1960	1961	1962	1963	1964	1965	1966	1967	1968
Capital/product ratio, including dwellings	2.23	2.21	2.20	2.20	2.19	2.24	2.42	2.53	2.31
Capital/product ratio, excluding dwellings	1.52	1.51	1.51	1.50	1.50	1.54	1.67	1.75	1.58

8. INVESTMENT IN INVENTORIES

Investment in inventories¹ in 1968 reached some IL 175 million at current prices, following a disinvestment of about IL 65 million the year before. The increase in 1968 was close to the average for the prerecession years.

The running-down of stocks in 1967 was apparently connected in the main with the prewar tension and the additional demand originating in the administered areas after the war. Another outcome of the hostilities was the reduction of meat imports from Eastern Europe. The pickup in economic activity, which began in the middle of 1967, failed to check the further depletion of stocks. The increased demand in the economy presumably exceeded the immediate growth of output, and was partly supplied from raw material and other inventories. In 1968 inventories were again built up following large-scale imports and the adjustment of domestic production to demand.

While the inventory increases in the various sectors of the economy in 1968 followed declines in the preceding year, they were not particularly large. Industrial stocks were up by some 7 percent,² while in agriculture the increase totalled 10 percent. Stocks of building materials were only slightly larger than in 1967. The strong demand for the output of this sector resulted in the current consumption of building materials matching the growth of production, so that no stocks were accumulated. On the other hand, wholesalers' stocks decreased, with a few individual items—mainly fuel and cotton—being responsible.

Food stocks of the Ministry of Commerce and Industry were enlarged by some IL 45 million in 1968, after shrinking by approximately IL 35 million the year before. Most of the increase in these stocks, the bulk of which is imported, occurred in wheat, sugar, and soybeans. The timing of Government purchases for the building-up of stocks largely depends on the forecast changes in the prices of these products in foreign markets.

9. FINANCING OF GROSS FIXED INVESTMENT

In discussing the financing of investment in Israel, a distinction must be made between private and public financing.³ Public financing consists of the direct

¹ Investment in inventories is estimated as the physical change in stocks between the beginning and the end of the year, valued at the average prices prevailing during the year. The estimate is thus not identical with the inventory changes reported by the concerns, the difference between the two stemming from price changes during the year.

² This estimate, which is based on quarterly inventory surveys carried out by the Central Bureau of Statistics, is very tenuous.

³ The definition of the public sector in this section differs from that used in the sectoral analysis of investment, where the Government, National Institutions, local authorities, and public sector companies were lumped together. Here only that part of the public sector companies' investment financed by the Government is included in public financing.

fixed investments of the Government, National Institutions, and local authorities; development budget loans and grants provided by the public sector for investment purposes; and the purchase of company shares by the Government. According to this classification, private financing consists of long-term loans granted to the private sector by financial institutions (except for their loans from earmarked Government deposits) and by insurance companies and social insurance funds, the purchase of company shares by the public, and investors' own capital. The last two items include private financing from abroad,¹ which in the last two years did not add up to a significant amount.

Table V-11

SHARE OF GROSS INVESTMENT FINANCED BY THE PUBLIC SECTOR, 1960-68
(percentages)

	Average 1961-64	1965	1966	1967	1968
Agriculture and irrigation	84	92	89	91	94
Industry and construction	24	7	11	52	34
Mining and quarrying	14	24	55	100 ^a	100
Electric power	22	38	23	19	29
Transportation and communications	45	54	70	79	62
Commerce and services	45	43	53	60	63
Total nondwelling investment	45	44	54	70	60
Housing	33	33	36	61	47
Grand total	41	40	48	67	57

^a Government loans to concerns engaging in mineral extraction exceeded their actual investments in 1967 and 1968. All of the excess went to the Dead Sea Works.

SOURCE: Investment data—Central Bureau of Statistics; data on public financing—Bank of Israel estimates.

The Government's influence on the direction of investments is actually greater than indicated by Table V-11. The Government controls a large percentage of the remaining sources of funds: it owns most of the financial institutions and stipulates which securities shall be approved for purchase by social insurance funds and insurance companies. The Government's control is reflected in the allocation of credit and the determination of financing terms.²

¹ Capital investments from abroad and the net participation of foreign investors in company share capital.

² See also Chapter XVII, "Financial Institutions".

The percentage of nondwelling investment financed by the public sector¹ declined in 1968. This is ascribable to the very rapid growth of investment, and the slower (but still substantial) expansion of public financing. Even though the relative share of public financing fell from 70 percent in 1967 to 60 percent in 1968, it was still of unprecedented proportions, since the exceptionally high figure for 1967 was due primarily to the sharp cutback in private sector investments. In each of the years 1961–65, the relative share of public financing stood at about 45 percent.

In 1967 the volume of public financing (other than for housing) rose by 14 percent, after remaining stationary in the three preceding years. The 1967 increase is explained by the Government's policy of stimulating economic activity, and especially of encouraging industrial investments. In 1968 the Government continued to foster investments, and the total volume of public financing for nondwelling purposes was expanded by some 28 percent. Nearly all of this increase was in the form of loans and grants, which grew by IL 230 million, whereas the public sector's direct investments increased to a much lesser extent—by only some IL 45 million.

Another major development in 1968 was the larger volume of grants provided under the investment law. These totalled IL 28 million, or about 22 percent of the total investment in approved industrial enterprises. Between 1960 and 1966 the weight of public financing in industrial investment moved steadily downward, but this change was purely of an institutional nature—the transfer to financial institutions of the function of mobilizing funds and granting loans therefrom. In 1968 the proportion of funds provided to industry by the public sector (excluding financial institutions) reverted to the 1960 level of some 35 percent. Thus in the year reviewed, the overall control of the public sector over the financing of industrial investments was increased, since the much larger volume of public financing supplied to industry in 1968 was not accompanied by a corresponding decrease in the credit granted to this sector by financial institutions from their own resources.

In the last two years long-term loans to the mining and quarrying branch considerably exceeded its outlay on fixed assets. Part of the sum was apparently used for financing stocks and investments implemented in the past, besides repaying loans falling due.

The financing provided for agriculture and water projects by the Jewish Agency and from the Government development budget was almost equal to the value of fixed investments in this sector. Some of the funds were earmarked

¹ The reference is to the weight of public financing in fixed investments, but it should be noted that long-term loans are used to finance all purchases on capital account and not only investments in fixed assets. Another limitation stems from the fact that the provision of financing and the actual implementation of the investment often do not coincide.

for financing the consolidation of certain agricultural settlements, and not for new investments.

The contribution of social insurance funds to the direct financing of private sector investment is small, since they invest chiefly in fixed-interest securities, for the most part approved bonds¹ issued mainly by the Government and financial institutions. Most of the loan capital provided by social insurance funds to business is given by Gmul Ltd., the funds' investment company. The volume of such loans is not large, amounting to IL 21 million in 1967 and IL 35 million in 1968.

Direct loans from insurance companies to business enterprises likewise do not add up to a very large sum; however, it should be noted that the overwhelming proportion of such credit goes to the Israel Electric Corporation and that it accounts for a considerable share of this concern's financing (some 26 percent in 1967 and about 21 percent in 1968). Insurance companies purchased approximately IL 18 million of Electric Corporation bonds in 1967 and IL 21 million in 1968.

In the past two years no new public issues of shares or bonds were floated by private business firms.

As to internal financing of investments, there was probably a substantial increase in 1968 as compared with the previous year. This is suggested by the steep rise in profitability in 1968,² which apparently was not accompanied by a significant increase in the proportion of distributed profits.³

¹ See also Chapter XVIII, "Social Insurance Funds and Insurance Companies".

² See section 3 above.

³ Studies have shown that the pattern of company profit distribution does not change greatly in the short run. See M. Tamari, "The Pattern of Industrial Corporate Profit Distribution in Israel, 1956-64", *Bank of Israel Bulletin*, No. 29.