

## CHAPTER 1

### MAIN ECONOMIC DEVELOPMENTS

After deteriorating badly in 1973–75, the country's balance of payments took a marked turn for the better in the year reviewed, thanks to a vigorous expansion of exports and the flattening of imports. The current account deficit was pared appreciably, falling to the level of long- and medium-term capital imports. This checked the economy's mounting dependence on short-term sources of finance and the shrinkage of foreign exchange reserves. But this improvement was achieved at a heavy price – the continued stagnation of the economy and aggravation of inflation.

The brighter balance of payments position can be ascribed to the rebounding of world commerce from its deep slump of the previous year, some improvement in Israel's terms of trade (reversing the trend of previous years), the weakening of domestic demands, and an increase in export profitability. In the middle of 1974 the government launched a concerted effort to bridle domestic demands – by hiking taxes and curtailing the public sector's domestic spending – and to stimulate exports and import substitution through fairly frequent mini-devaluations. This policy of creeping devaluation was pursued against the backdrop of the slowdown of domestic demands (which grew more pronounced in 1976), the buildup of spare productive capacity, and some softening of the labor market. But soaring production costs limited the export profitability gains.

Even though the economy remained static in 1976, inflation continued at a high rate and even sharpened in the course of the year; by the end of December the consumer price index stood 38 percent above its level the year before. Since 1976 saw a more resolute implementation of the policy of creeping devaluation and higher taxation, prices were pushed up, causing labor to demand pay increases. The resulting growth of wages and profits sent prices spiraling up again, sparking another round of wage demands. This reflected the labor market situation in general and the scope of overt unemployment in particular. The fact that in 1976 too the continued stagnation of the economy was not accompanied by any extensive overt unemployment helped to fuel inflation. It is noteworthy that monetary developments did not generate demand pressure on prices this year.

The policy of cooling domestic demands was, even more so than in 1975, a two-pronged one. On the one hand, it put a damper on the direct domestic demands of the public sector, namely civilian consumption, the sector's direct investments, and publicly sponsored housing construction. Secondly, in order to restrain private consumption it reduced the real disposable income of the private sector through an increased fiscal absorption (direct and indirect taxes, less transfer payments and subsidies). However, the

TABLE I-1  
**MAIN ECONOMIC INDICATORS, 1971-1976<sup>a</sup>**  
 (percent annual increase, unless otherwise stated)

	Average			1971	1972	1973	1974	1975	1976
	1961-65	1966-67	1968-70						
<b>Resources and uses</b>									
(at constant prices)									
Total domestic uses	10.5	1.4	14.5	7.7	7.1	18.8	5.0	2.6	-4.1
Gross domestic product <sup>b</sup>	10.0	2.0	12.1	10.5	12.1	6.9	6.6	2.2	1.0
Gross domestic product-business sector (excl. residential rents) <sup>c</sup>									
Total	10.9	-0.1	14.5	11.9	13.7	4.3	6.6	1.5	0.1
Per employed	6.1	3.7	8.6	6.7	5.6	3.4 <sup>d</sup>	6.7 <sup>d</sup>	2.0	0.4
Real disposable private income <sup>e</sup>	10.6	3.5	8.7	11.7	14.0	11.2	-5.6	-3.0	-6.5
Private consumption									
Total	10.3	2.3	8.4	4.9	9.1	9.3	8.0	0.0	4.1
Per capita	6.1	-0.6	5.2	1.8	4.9	5.6	4.9	-2.3	1.9
Public consumption	10.6	21.4	17.1	1.3	-1.9	46.4	2.1	10.5	-7.8
Thereof: Civilian consumption		5.4	5.3	5.1	7.9	6.9	4.0	6.6	5.1
Gross investment	11.3	-19.1	28.5	21.8	12.9				
Public sector <sup>f</sup>						5.7	7.1	4.9	-20.7
Other, incl. ships and aircraft						12.7	0.7	-5.0	-11.0
Balance of payments $\mathcal{E}$ , excl. trade with administered areas (in dollars)									
Imports	12.0	7.2	22.0	16.2	5.9	63.3	29.6	11.3	-1.8
Exports	15.6	11.4	13.5	32.7	17.4	24.6	30.1	1.7	17.4
Import surplus (\$ million)				1,265	1,131	2,670	3,447	4,165	3,415
External debt (\$ million)				3,430	4,081	5,093	6,250	7,617	9,371
Foreign exchange reserves <sup>h</sup> (\$ million)				575	1,070	1,697	1,071	1,040	1,156

Population and employment									
Average population	3.9	3.0	2.9	3.0	3.3	3.3	3.0	2.3	2.2
Number of Israeli employed	4.8	-2.5	4.8	3.5	5.0	3.9	0.1	1.2	1.3
Unemployment rate (as percent of civilian labor force)									
– absolute figures	3.6	8.9	4.8	3.5	2.7	2.6	3.0	3.1	3.6
Prices and national income (nominal)									
Average monthly earnings per employee post <sup>d</sup>	13.6	9.4	6.1	16.4	13.6	27.5	36.1	36.7	32.6
GNP price deflator	8.0	4.8	4.4	12.7	14.2	20.8	35.3	35.9	25.4
Import prices <sup>i</sup>	9.7	2.1	7.7	16.2	20.2	20.2	39.3	43.0	33.9
Consumer price index (annual average)	7.4	4.8	3.6	12.0	12.9	20.0	39.7	39.3	31.3
National income	18.8	6.5	17.0	24.2	28.6	28.2	42.4	34.9	22.4
Finance (annual average)									
Money base <sup>k</sup>	18.9	13.6	11.6	34.6	47.5	24.0	5.4	26.4	18.0
Money supply	17.6	13.6	10.2	22.4	30.1	25.3	19.8	31.0	17.7
Other liquid assets of the public	32.5	23.7	26.5	29.8	27.6	21.3	23.6	48.6	36.8
Bank credit to the public <sup>l</sup>	19.6	20.9	16.0	24.1	17.4	26.8	48.4	53.0	34.0

a Until 1968 the percentage changes were calculated on the basis of the previous year's prices, but since 1969 the rates of real change have been calculated on the basis of constant 1970 prices.

b Valued at the effective rate of exchange.

c Defined as the total product, less public sector and nonprofit institution services.

d Per effective employed: i.e. excluding private sector employed called up for active or reserve duty.

e Gross disposable private income from domestic sources, before deducting compulsory loans.

f Government, local authorities, national institutions, government business-type enterprises, nonprofit institutions, and public residential construction.

g Goods and services (imports CIF and exports FOB).

h Net foreign currency balances in the Bank of Israel at the end of the year.

i Israeli employee posts, including part-time and supplemental work. Since 1969 a new series based on National Insurance Institute data, which include *inter alia* East Jerusalem.

j Includes changes in foreign prices and in the effective exchange rate of the Israeli pound.

k Currency in circulation with the public, plus total liquid assets of the banking institutions.

l Until 1970 includes bill brokerage credit.

attempt to curb private consumption did not prove very effective, for consumers drew on their savings. At the same time, public civilian consumption continued to rise and the public sector took on additional personnel. Domestic defense expenditures, on the other hand, sagged further in 1976, and nondwelling investment was cut back sharply in a lagged response to the protracted economic slowdown. The downturn in investment (notably in construction) and domestic public spending (mainly on security) is estimated to have directly reduced the business sector product by 4-5 percent. The rise in private consumption, on the other hand, added about 2 percent to the product, and another 4 percent was accounted for by the 13 percent advance in exports (after edging up 2 percent in 1975). These contrasting forces were reflected by disparate growth rates in the various sectors of economy. Whereas construction output slid precipitously and the services rose only fractionally, further healthy gains were posted by industry, transportation and communications, and agriculture, despite the ebbing of domestic demand; this can be mainly credited to the big strides made by exports.

The harnessing of domestic demands made its impact felt mainly on civilian imports, which in 1974-76 inched up less than one percent p.a. in real terms, as opposed to a 14 percent yearly average increase in 1970-73. Besides its beneficial effect on imports, the slackening of domestic demands led to the expansion of exports both directly — in the main by channeling noncivilian production from public consumption to exports — and indirectly — by creating manpower reserves for export industries and blunting to some extent the rise of prices and domestic production costs.

The easing of the balance of payments strain and the lifting of the threat of a financing crisis were achieved, as stated, at the price of forgoing economic growth. It is hard to precisely calculate by how much GNP could have been expanded had it been possible to fully exploit the available factors of production under normal conditions, but the computations give some notion of the gap between potential and actual GNP. If the economy did not have to cope with such a serious balance of payments problem, and if it did not have to check the growth of imports and increase the weight of exports, it is estimated that 15-20 percent could have been added to GNP. The existence of spare capacity was reflected by the underutilization of capital in numerous sectors and by general underemployment of manpower. Nevertheless, overt unemployment did not appear until the final part of 1976. There was probably a redundancy of labor, considering the level of economic activity, but the slowdown was reflected more in hidden than in overt unemployment.

Since 1974 several mini-devaluations have been implemented, reducing the effective rate of exchange for exports by 69 percent all told<sup>1</sup> and by 25 percent in 1976 alone. The stiffening of direct and indirect taxes brought up their weight<sup>2</sup> from 39 percent

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<sup>1</sup> The reference is to the effective rate of devaluation for the highest incentive group.

<sup>2</sup> The weight of taxes, including those on imports, and compulsory loans.

of GNP in 1972 to 51 percent in 1976. In indirect taxation the most striking change was the institution of an 8 percent value added tax (VAT) in July. The growth of direct tax revenue stemmed from a more efficient collection and the broadening of the tax base in the wake of the income tax reform. As opposed to this, transfer payments to households and nonprofit institutions soared 80 percent between 1972 and 1976 (about 4 percent of the 16 percent increase in 1976 stemmed from the changeover, under the tax reform, from a system of tax allowances for dependent children to the direct payment of such allowances by the National Insurance Institute). These transfer payments reduced the overall net tax burden of the economy, with the result that they expanded much more slowly than the weight of taxes in the product. But they did not prevent the negative repercussions of the higher taxes on the price level, and they might have even reduced somewhat the supply of labor. Indeed, after the immediate effect of the introduction of the VAT in July and the slashing of subsidies in October wore off, inflation began to slow in the first months of 1977. It should be stressed, though, that if the appreciable pay rises won by public servants in 1977 lead to similar rises in the business sector, the price advance will again speed up.

In the past the existing institutional arrangements — the cost-of-living allowance agreement, indexation of savings, and the system of creeping devaluation — helped to neutralize some of the negative effects of inflation. But when inflation reached 35-40 percent in 1976, it became clear that these arrangements lost some of their effectiveness, for the following reasons:

1. The cost-of-living agreement, under which wages are now pegged only 70 percent to the rise in the consumer price index, sharply reduced real wages in the face of mounting inflation. But the outcome was an increase in labor disputes, the demanding of wage adjustments, and the reopening of agreements signed under the assumption of a lower rate of inflation.

2. The partial indexation of new bond issues to the public (i.e. by less than the rise in the consumer price index) depressed the real yield on such securities and, along with the reduced yields on other savings instruments, pulled down the rate of saving. Working in the same direction was the nonindexation of loans granted by the public sector, which augmented the public's wealth.

3. The implementation of frequent mini-devaluations hardly succeeded in keeping the external value of the IL abreast of the rate of inflation.

The mini-devaluations made exports a little more profitable, as measured by various indicators. The prices of goods and services traded internationally (exports and import substitutes) outstripped the price rise of nontradables (mainly construction and services), industrial export prices rose faster than domestic prices, and in the export industries production costs went up to about the same extent as the prices commanded abroad. Although export profitability failed to reach the desired level, and while part of the gain can be credited to random influences (such as an improvement in the terms of trade),

the increase achieved goes a long way to explain the notable progress made by the country's overseas sales in 1976. An even greater improvement in export profitability might have produced a bigger advance than that actually recorded, but presumably the labor supply, marketing organization, and capacity constraints would have neutralized, in the short run, the impact of this additional improvement. On the other hand, it seems that, because of the absence of large-scale overt unemployment, profitability could have been raised further only by stepping up the mini-devaluations, which in turn would have pushed up prices still more rapidly.

The gross domestic product of the business sector held steady, or drifted up a notch, after a niggardly 1.5 percent rise in 1976. As in the two preceding years, the product originating in agriculture continued to expand strongly, for this sector was not affected by the general slowdown. Contributing to the output advance this year were the growth of overseas sales and the heavier subsidization of cattle and poultry farming, which resulted in a large oversupply. Industry and mining and quarries posted above-average gains, led by a resounding increase in exports, while domestic sales fell off, mainly in building materials.

Construction output (including electricity and water) slumped 13 percent. This was connected with the curtailment of public residential construction, which responded belatedly to the ebbing of home demand in recent years, and also with a sharp drop in defense construction. The product originating in transportation and communications was up 7 percent, mainly because of a boom in tourism to this county. Despite the flagging demand for labor due to the stabilization of the business sector product growth rate, no overt unemployment appeared, although manpower survey data point to some weakening of the labor market toward the end of the year (provisional data show that this trend carried over into the early part of 1977). There was some redundancy of labor, as reflected by the sluggish growth of product per manhour in the economy as a whole and in construction in particular. While the absence of overt employment cannot be satisfactorily explained as yet, it can probably be attributed to the following factors:

1. The decelerated expansion of the labor supply, due to the slower growth of population because of a fall-off in immigration, and a decline in the labor force participation rate, the number of administered area residents working in Israel, and manhours worked per employed.

2. The growth of personnel in the public services. Between 1973 and 1976 some 40,000 names were added to the payroll, whereas in the business sector the number of Israeli employees fell by 8,000.

3. The economic slowdown was accompanied by fluctuations in the level of activity, which engendered expectations of a resumption of growth.

As in 1975, total resource use rose very sluggishly, by 1 percent, after a marked increase in previous years. But the 1976 growth pattern differed substantially from that the year before. Whereas in 1975 exports inched up only a little more than 2 percent,

with private consumption rising 4 percent and domestic public consumption and gross domestic investment (excluding ships and aircraft) retreating by 3 and 14 percent respectively.

The sharp drop in total investment was due to a combination of factors:

1. The government cut back its capital expenditures under the policy of dampening domestic demands.

2. Housing construction was curtailed as demand fell off because of overbuilding in earlier years and the sagging of immigration and income. In public residential construction there was a lagged response to the faltering of demand; thus the volume of starts rose strongly until the beginning of 1975, even though the demand situation did not warrant this. The result was a sharp 29 percent fall in such investment in 1976. The adjustment of private construction to slumping demand was a more gradual process, beginning as early as 1973. In 1975 and 1976 such building was cut back by 3 and 8 percent respectively.

3. The 19 percent contraction of private nondwelling investment, after it had remained unchanged in 1975, is explained by the economic slowdown and a low capital utilization rate. The downturn probably would have been even sharper had it not been for the larger amount of directed financing (credit and grants) made available in 1976 under the Law for the Encouragement of Capital Investments (such financing is heavily subsidized).

4. Inventory investment fell off because of the business situation and such special factors as the expectation of a more modest increase in world raw material prices and a rise in interest rates, which made stockpiling more expensive.

Public consumption was down 8 percent in real terms, mainly because of a steep fall in direct defense imports. Most of the decline in domestic public consumption was also in defense spending, which was cut back 7 percent after a 4 percent drop in 1975.

In contrast to the curtailment of public defense spending, the sector's civilian consumption was up 5 percent despite the policy of restraining demands; this followed a 7 percent rise in 1975. The increment reflected a 7 percent increase in purchases (the same as last year) and a 4 percent growth of employment (following a 7 percent rise in 1975). The expansion of personnel was contrary to the policy of cooling demand in the labor market and of diverting manpower to production, especially for export. It stood out all the more in the light of the decline in business sector employment compared with the period before the Yom Kippur War.

Real GNP drifted up 1 percent, while gross disposable income of the private sector from domestic sources retreated about 6 percent (8 percent per capita).

After holding steady in 1975, private consumption moved up 4 percent in 1976 (2 percent in per capita terms, after falling to the same extent the year before).

The rate of saving out of disposable private income from domestic sources sank to 23 percent in 1976, after edging down from 33 to 30 percent the year before. No fully

satisfactory explanation can be offered at present for this much poorer saving performance. One possibility is an error arising from the provisional nature of the product and consumption data. The main reason might be the noticeable shrinkage of real disposable income over the last two years, and especially in 1976. The consuming public presumably does not immediately adjust its spending to a change in income. Part of the drop in the saving rate was apparently connected with the government's action in the capital market at the end of 1975, which heightened fears of further steps to impair the yields on indexed financial assets. It should be borne in mind that the worsening of new bond issue terms resulted in a once-and-for-all appreciation of their real value, and this undoubtedly diminished the desire to save.

Another possible reason lies in the disparate thrift habits of employees and nonemployees. Since the labor share of national income rose appreciably in the last two years, this in itself probably depressed the saving rate, a trend reinforced by the increase in direct tax revenue from nonemployees and in transfer payments to low-income groups.

Still another possible explanation lies in the makeup of the private sector's net liabilities to the government: its debts to the government are unlinked, while most of the directed financing obtained from the government is linked to the index, so that inflation increased the sector's real wealth and depressed the rate of saving from current income.

The year reviewed saw an abrupt drop in the balance of payments deficit on current account, from \$ 4.1 billion to \$ 3.3 billion. This can be credited to the respectable headway made by exports (up 13 percent in real terms) and to a slight downswing in imports (2 percent). Some \$ 240 million of the decrease in the deficit stemmed from the curtailment of direct defense imports.

The nongrowth of imports reflected, first and foremost, the standstill in economic activity which has persisted since the middle of 1974. Required imports of nondiamond intermediates, calculated according to input-output coefficients, were 4 percent higher in 1976; the increment consisted of a 2.5 percent decline in direct and indirect inputs for domestic uses and a 22 percent increase in inputs for export production.

The 8 percent actual reduction of imported inputs was a compensatory response to the buildup of such stocks in 1975, and was spurred by the rise in interest rates. Conversely, rough diamond stocks expanded, while imports of capital goods other than ships and aircraft were down 7 percent, with plant and equipment falling off 9 percent — a clear manifestation of the economic slowdown.

All the export gain was in commodities, which were up 22 percent in real terms; they were paced by industrial goods other than diamonds, minerals, and fuel, which forged ahead 28 percent, and by noncitrus farm products, which advanced 30 percent.

The strong expansion of industrial exports, after four years of very laggard growth (an average of 6 percent p.a. in 1972–75), can be mainly attributed to three factors: a sharp pickup in world demand with the recovery of business in the developed countries at the end of 1975 and even more so in 1976; the lacklustre tone of Israel's economy

and the subsiding of domestic demand; and an increase in export profitability. Defense items made a major contribution to the expansion of overseas industrial sales (other than diamonds, minerals, and fuel) in the last two years. Excluding such items from the figures reduces the growth rate from 28 to 15 percent. This export, which consists of high-technology products and is of a special character, provides an example of the diversion of production initially geared mostly to the domestic market to the foreign market.

The most striking development in the capital account in 1976 was the reduction of the deficit on goods and services to the level of long-term capital imports — \$ 3.3 billion. This ended the economy's mounting reliance on short-term sources of finance which, together with the contraction of the country's foreign exchange reserves, had grown by some \$ 2 billion during the two preceding years.

The year reviewed witnessed a continuation of the major 1975 trends in long-term capital imports. Most prominent among them was the heavy dependence on U.S. government defense-related aid, which reached 53 percent of the total of unilateral receipts and long-term loan capital (55 percent in 1975), after jumping from 8 percent in 1969 and a 19 percent average in 1971–72 along with the growth of the defense import bill.

There was, however, an improvement in the composition of the capital inflow: a significant rise in the weight of unilateral transfers and a decline in long- and medium-term loans. This was chiefly due to a structural change in U.S. aid. The weight of unilateral transfers rose precipitously (from 35 to 69 percent), while that of the other types of transfers taken together fell off, an increase in Jewish Agency and nonprofit institution transfers being more than offset by a downturn in private transfers. The decrease in private transfers continued the trend of the past few years. The inflow of investment capital from abroad shrank further in 1976. Despite the impressive improvement in the balance of payments — the narrowing of the gap between long-term capital imports and the current deficit — the economy continued to turn to short-term foreign sources, although on a much smaller scale than in 1975; at the same time, however, foreign exchange reserves at the Bank of Israel expanded.

As regards credit, whereas the measures taken by the public sector with respect to direct demands and taxation had a restraining influence, its credit operations had a mixed effect. Only a small proportion of the financing is granted within the framework of the budget; in the main it is supplied through financial institutions in accordance with public sector directives. Budgetary investment credit was down 14 percent in real terms, which was consistent with the restrictive policy pursued by the government in implementing direct public sector investments. Also in the financing of investments by financial institutions, through which is channeled most of the investment capital to industry and agriculture and for the purchase of homes, there was a 3 percent real decrease. Most of the decline was in directed credit for housing and construction, whereas that for financing industrial and agricultural investments (and private housing) rose in constant price terms, despite the cutting back of investments in these sectors. This greatly increased the rate of

financing, thereby keeping investments from falling even more steeply in the wake of the protracted stagnation of the economy. But this must be viewed in conjunction with the substantial excess capacity existing in some sectors and an inadequate selectivity in financing industries marketing most of their output abroad.

Net issues of IL indexed bonds (the use of whose proceeds is directly and indirectly determined by the government, which shoulders most of the burden of covering linkage differentials) tumbled 55 percent in real terms, after declining 15 percent in both 1974 and 1975. This sharp downswing reflected the drop in household saving with the reduction of disposable private income, but undoubtedly it was also an outcome of the worsening of indexed savings terms, coupled with the decline in the rate of return on savings (foreign currency assets, homes, etc.). The poorer saving performance may have neutralized much of the dampening effect of higher taxation on private consumption, for which the economy had to pay a stiff price in the form of an aggravation of inflation, with all its harmful repercussions.

The public sector's net credit transactions resulted in a niggardly IL 400 million liquidity absorption in 1976, compared with a IL 6.1 billion absorption the year before. Together with the effect of the sector's demand surplus, there was a IL 7.8 billion injection in 1976, compared with IL 5.5 billion in the previous year. But the amount pumped into the economy in 1976, which was equivalent to 90 percent of the money base at the beginning of the year, did not intensify aggregate demand pressure or the rate of inflation even though the uptrend in the amount siphoned off by way of foreign currency sales to the private sector was checked. This is explained by the energetic restrictive monetary policy measures introduced, mainly with respect to nondirected credit and interest rates. The rise in the money supply trailed behind that of prices, amounting to 18 percent on an annual average and 27 percent in end-year levels. The appreciable contraction of real money balances was chiefly due to the further ebbing of demand for money in the face of mounting inflation and the upping of interest rates; consequently, one cannot learn from this to what extent there was monetary restraint this year.

The final months of 1976 and the beginning of 1977 saw a reversal of trend, with an increased liquidity injection on the one hand and some weakening of inflationary expectations on the other. Nondirected bank credit and directed credit for financing domestic operations also expanded modestly in 1976; the former averaged 29 percent higher this year, roughly the same as the growth of domestic uses, but the increase in end-year balances came to only 24 percent (far short of the rise in the consumer price index); the interest rate on such funding was hiked by 8 points. The trailing of incremental credit behind the advance of prices was even more conspicuous in directed credit; here too the interest rate was raised. By contrast, in 1976 the authorities followed a policy of channeling credit to export, as evidenced by the much larger sum made available through the export funds — a rise of 45 percent on an annual average (and in end-year levels), which matched the increase in the rate of exchange and the growth of exports in foreign

currency terms. That monetary expansion was relatively modest in 1976, despite the swelling of the money base narrowly defined and an increased potential for further growth, can be attributed, as mentioned, to the various measures initiated during the year. The 46 percent expansion of the money base was mainly an outcome of two developments: a much larger public sector liquidity injection in the course of the year, which was generated partly by the budget of deficit and partly by the conversion of foreign currency by the government and Jewish Agency for financing domestic activities, and the checking of the uptrend in liquidity absorption by way of foreign currency sales to the private sector. The decrease in the amount siphoned off was much smaller than warranted by the notable improvement in this sector's balance of payments, for it relied less heavily this year on short-term borrowing from abroad. The system of mini-devaluations also resulted in a larger absorption through foreign currency sales to the private sector. The Bank of Israel, as mentioned, countered the expansionary effect of directed credit by restricting nondirected credit and making it more expensive, and saw to it that part of the increase in the money base was used to reduce the banks' sizable liquidity deficiencies at the beginning of the year.

The hiking of the bank lending rate also discouraged the use of such credit for financing speculation in foreign currency. The principal step taken by the central bank was the provision to the banking institutions of a IL 400 million stop-gap loan, bearing 20 percent interest, in order to enable them to reduce their shortfalls in liquid asset cover. The loan was made conditional on the banks' limiting the growth of nondirected credit, an arrangement that made it much more costly to step up marginal credit beyond the limits fixed.

To sum up, in the face of the drastic erosion in 1973–75 of the balance of payments position, which entailed a heavy resort to short-term sources of funds and the severe drawing down of foreign currency reserves (which totaled some \$ 2 billion in 1974 and 1975), it became imperative to take energetic action in 1976 to immediately reduce the dimensions of the problem and to avert the danger of a grave balance of payments crisis, even at the high price of economic stagnation, contraction of investment, and a temporary aggravation of inflation.

Part of the improvement in the balance of payments — that connected with the arresting of import growth — was of a short-term nature, associated with the government — induced business slowdown. With the resumption of economic growth, the uptrend in imports will reassert itself owing to the economy's dependence on foreign raw materials, which account for most of the overseas purchases.

The renewal of economic growth while preserving the 1976 balance of payments gain and advancing toward a long-term solution of the problem therefore depends on the accelerated expansion of exports in the years ahead and the controlled cooling of domestic demands. The curtailment of domestic demands and stimulation of overseas sales go far to explain the much better export performance this year. Moreover, the business slowdown brought about by the policy of restraint has resulted in plenty of spare

capacity, part of which can eventually be diverted to export production. This excess capacity, along with the weakening of the labor market, can bring about the required structural change in employment and resource use. But since the middle of 1975 the government's retrenchment policy has largely relied on fiscal absorptive measures, such as the hiking of indirect taxes and the slashing of subsidies on essential items. While these have greatly helped to dampen domestic demands, they have added fuel to the inflation, both directly and indirectly, thus largely nullifying the effectiveness of the devaluation in enhancing export profitability, not to mention the other harmful effects of a protracted galloping inflation.

In the near future the government should refrain, as far as possible, from absorbing liquidity through taxation (except, of course, to augment revenue from this source, which is connected with the streamlining and more efficient collection of taxes and prevention of tax evasion), and it should take more determined action to curtail public spending and encourage thrift.

Boosting the rate of saving is more effective than fiscal absorption as far as influencing domestic demands goes. As pointed out, the drop in the saving rate in 1976 was due, at least partly, to the adverse change in financial savings terms and uncertainty about future developments here; it is therefore important to consider the offering of more attractive terms.

Considerable importance attaches to the freezing of personnel in the public services after the big increase of recent years, contrary to policy. The curtailment of manpower and purchases of the public sector must be accompanied by a policy of selective wage restraint, which would permit the mobilization of essential labor and avert steep wage hikes in most sectors of the economy. Employees' earnings ought to be adjusted more slowly in the public services than in the productive sectors, in order to bring about the necessary allocation of manpower. In addition, the growth of transfer payments to households should be retarded through a more selective policy.

If the government avoids steps directly affecting the price level, this, together with the existing unutilized productive capacity, will help to slow down inflation and make the devaluations a more effective instrument. If inflation is significantly bridled, the required improvement in export profitability could probably be achieved through a less frequent implementation of mini-devaluations, which in turn would further weaken the inflationary spiral.

To achieve the necessary structural change in the national product entails an appropriate employment of manpower. Toward this end, the government must follow a policy that will remove the present obstacles to labor mobility, such as greater flexibility in transferring workers' social benefit rights, which would facilitate the shifting of labor from the services to export production. In addition, export enterprises must be assisted in training the types of labor they need.

The reduction of the import surplus has also left its impress in the monetary sphere. An export-led resumption of economic growth implies a monetary expansion, both because of a smaller purchase of foreign currency by the private sector (due to the dent in the import surplus and the expansion of private capital imports) and because of an increase in directed export credit. To cope with the monetary problems likely to arise, the authorities have to make the monetary policy instruments more flexible in general and conduct more active open-market policies in particular.

The blunting of import growth at the price of economic stagnation was a suitable short-term expedient for lifting the threat of a grave balance of payments crisis. The long-run solution, however, lies in the renewal of economic growth with a steadily shrinking import surplus. This can be attained only through a healthy advance in overseas sales, spurred by an increase in export profitability and the restrained, controlled growth of domestic uses, with all the changes this entails in the structure of the economy.