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Chapter 2

Comprehensive Control and Partial Liberalization: The 1950s

In the main, this chapter contains a detailed description of the machinery and attributes of the comprehensive restrictive system of Phase I, the years 1949–51. It also includes an explanation of how the radical policy changes introduced during 1952–54 (Phase III), as well as the milder and more gradual changes of 1955–61 (first stage of Phase IV) have altered the nature of the system.

i. ORGANIZATION OF THE SYSTEM OF QUANTITATIVE RESTRICTIONS [1]

The legal and institutional framework for quantitative restrictions on foreign trade was inherited by the government of Israel in 1948 from the mandatory government of Palestine. Administrative regulation of trade was first introduced in 1939 when World War II broke out. The Ordinance of Imports, Exports, and Customs, by which the regulation was imposed, was originally meant to prevent trade with the enemy during the war. Yet it has served since then as the basis for intervention which, during most of the time, has had nothing to do with trade relations during wartime. The main feature of the ordinance, which made it the legal basis for the regulatory system, was the prohibition of any imports unless licensed by the "competent authority" appointed by the government for this purpose.

During the first few years of the state's existence—the late 1940s and early 1950s—import licenses were issued by several competent authorities,

without any central regulation, although most import items were the domain of one ministry. This ministry has changed its name, as well as its structure and some of its functions, several times; but since 1951 it has remained the Ministry of Commerce and Industry. Along with an import license from the relevant competent authority, an importer had to obtain a currency allocation from the Controller of Foreign Exchange in the Ministry of Finance.

During 1952 the concept of the "foreign-exchange budget" was introduced into the regulatory system. In early 1952 an experimental budget was prepared for 1952–53.[2] Later in the year, a Department of the Budget was established within the Ministry of Finance, and it undertook the preparation of a foreign-exchange budget, starting with the budget for 1953–54. From then on until 1964, an annual foreign-exchange budget was prepared and submitted for cabinet decision, along with the conventional parts of the government's budget. The government's basic policy decisions on the allocation of foreign exchange were thus made in the adoption of the annual foreign-exchange budget.

The preparation of a foreign-exchange budget followed normal procedure for budgetary planning. Some six months before the new fiscal year, the department of the Budget would issue directions to the competent authorities within the various ministries, providing them with rough guidelines for presentation of foreign-exchange requirements.[3] At the same time, the Budget Department, with the help of the Foreign Exchange Department of the Ministry of Finance, would make an estimate of forthcoming foreign-exchange receipts. These receipts included export proceeds, unilateral cash transfers to Israel, and long-term and some medium-term loans. The selection of medium-term loans to be included was left to the discretion of the Department of the Budget. Short-term loans and the use of foreign-exchange reserves were not included in estimated receipts. Most transfers in kind, whether unilateral or on capital account, were included in the budget. This applied, among other things, to some major items such as German reparations or U.S. food surpluses. Minor transfers in kind, such as personal gifts or immigrants' personal effects, were excluded.

When estimated requirements of the various competent authorities were in hand, they were compared with estimated receipts and, not surprisingly, the former were found to exceed the latter. The Budget Department, following the normal course of budgetary negotiations with the ministries, then cut the allocations to the various authorities and proposed a foreign-exchange budget. This proposal was submitted by the Minister of Finance to the Cabinet Committee for Economic Affairs and then to the cabinet as a whole. The adoption of the budget by the cabinet made it an operational administrative directive. In this last step, the foreign-exchange budget differed from the conventional

parts of the budget, which the cabinet had to submit to the Knesset for approval.

Once a foreign-exchange budget was approved by the cabinet, it provided a general allocation plan for the competent authorities. Within the limits of the quotas allocated, each authority was empowered to issue import licenses for the various items which it handled. An import license thus issued had to be approved by the Controller of Foreign Exchange, whose function—parallel to that of the government's controller in authorizing normal budgetary expenditures—was to check whether the license indeed fell within the authorized budget. The approval by the Controller of Foreign Exchange made the import license valid and also automatically resulted in commitment of the required foreign exchange, which was then provided when payment for the import was due. An exception to this rule was for import licenses labeled as "without allocation of foreign exchange"; these included substantial categories of import transactions, some of which will be mentioned later. Also subject to the approval of the Controller of Foreign Exchange were the terms of payment (cash, supplier's credit for a certain duration, etc.) and the currency of payment: the Controller could, and very often did, specify that only one currency and no other could be allocated for the import for which a license had been granted. This provision was mostly used to turn away imports from "hard currency" countries to countries with which Israel had payments and clearing agreements.

The foreign-exchange budget allocated licensing quotas among *functions and purposes* of the imports, rather than explicitly to competent authorities. The most general classification specified four categories: consumption, imports for exports, investment, and debt servicing (starting with the 1958–59 budget, services were separated from consumption and made into another category). These were subdivided into a three-digit classification, corresponding to the main industrial branches. The latter were then further divided by a five-digit classification, and this was the one with effective meaning: each five-digit item was handled by a particular competent authority. Five-digit items could be physically similar but classified as separate items if intended for purposes which were within the domains of separate authorities. For instance, a truck would fall under one item if intended for use in an industrial plant, another if intended for agricultural use, and still another if purchased for the use of a port authority.

As mentioned, 1952–53 was the first year for which a foreign-exchange budget was prepared, and the budget-making process in its entirety became effective in 1953–54. The last year for which such a budget was prepared was 1964–65. The budgets for all these years, by major classifications of receipts and expenditures, are presented in Table 2-1.

TABLE 2-1

Foreign-Exchange Budgets, Fiscal[a] 1952–64

(millions of dollars)

	1952[b]	1953[b]	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
Approved budgets													
Receipts	215	233	310	346	480	519	587	590	685	795	910	1,030	1,190
Exports of goods and services	32	35	66	88	139	186	216	225	305	365	435	530	610
Other receipts	183	198	244	258	341	333	371	365	380	430	475	500	580
Expenditures	185	233	310	346	480	519	587	590	685	795	910	1,030	1,190
Consumer goods	141	138	184	229	250	294	184	176	198	207			
Capital goods	22	37	85	77	119	98	140	140	170	204	550	620	660
Imports for exports	21	21	40	38	69	87	80	80	92	115			
Services	—	—	—	—	—	—	130	143	177	207	260	325	420
Debt servicing and reserve	—	—	—	—	42	38	47	51	48	63	100	85	110
Budgetary performance													
Receipts	181	260	345	357	516	548	608	668	796	884	1,008	1,170	1,207
Expenditures	185	191	356	396	529	570	574	631	734	865	879	1,081	1,023

SOURCE: Nadav Halevi, "Exchange Control in Israel," in Pierre Uri, ed., *Israel and the Common Market* (Jerusalem: Weidenfeld and Nicolson, 1971; in English), p. 45.

a. Fiscal year begins in April.

b. In 1952 and 1953, the budgetary data are for the first nine months only of the fiscal year.

The aggregates presented in the table reveal some interesting phenomena. First, it appears that actual receipts were consistently underestimated in the budget. Therefore, since the principle of a balanced foreign-exchange budget was always maintained, budgeted expenditures were always below actual receipts for the year.[4] This was apparently not a coincidence, but resulted from a deliberate policy of leaving in the budget some concealed, or implied, reserve or safety margin. It could even be guessed, from the figures in Table 2-1, that this was done by the use of some particular naive model, which was known always to yield an underestimate. It may be observed that with the exception of the comparison of 1956–57 with 1955–56, the *planned* (i.e., anticipated) receipts of one budgetary year were remarkably similar to the *actual* receipts of the preceding year; there is definitely a much closer similarity than can be observed in comparisons of anticipated and realized receipts for the same year. One may speculate that the budgetary planners used estimates of receipts in the current year in which they were working as a projection, perhaps with a few adjustments, of receipts for the next year, realizing (or, at least, correctly hoping) that normally this would yield an underestimate of receipts.

It also appears that in the large majority of the budgetary years, actual expenditures were higher, mostly by a substantial margin, than planned expenditures. This was made feasible partly by the availability of the surplus of actual over anticipated receipts. Even so, it is worth inquiring what made expenditures reach the higher levels, since automatic adjustments of expenditures to receipts are obviously not provided in the budgetary mechanism.

The gap between actual and planned expenditures is explained in a number of ways. One is that supplementary budgets were very often presented and adopted during the course of the year (a procedure, incidentally, often practiced in Israel with regard to the conventional parts of the government's budget). In this way, the surplus of realized foreign-exchange receipts could be allocated for expenditure. Thus, the foreign-exchange budget was, in effect, quite flexible and subject to changes during the course of the year, a purpose which was served by the practice of underestimating receipts.

Supplementary budgets were often prepared retrospectively. Expenditures exceeding the sums allocated in the original budget were commonly made without the sanction of a supplementary budget. The office of the Controller of Foreign Exchange, which was in charge of supervising the execution of the budget through the authorization of import licenses, without which the licenses were not valid, did not, as a rule, adhere too closely to the budget. It authorized expenditures over the planned quotas, in amounts which were determined by something close to supply and demand forces, that is, by the amount of pressure of potential importers (expressed through the various competent authorities) and the size of the flow of foreign-exchange receipts. It also ap-

pears that the Controller assumed, from experience, that import licenses might not be fully utilized: some of them did not result in imports even after many months. The Controller therefore issued import licenses beyond the amounts allocated in the import plans, even without having an extra supply of foreign exchange, anticipating that since the licenses would not be fully used, there would be no extra pressure on the supply of foreign exchange.

In contrast to the case of foreign-exchange allocation among goods or competent authorities, for which procedures existed, a mechanism or a set of rules for allocating import quotas for goods among users or importers was lacking. At the beginning, the "past trade" principle was apparently applied most often; but according to the available evidence its importance declined as time passed. Instead, in many cases, particularly when imports of raw materials were concerned, the decision on allocation was placed in the hands of trade or manufacturers' associations: the entire quota would be turned over to the association, which would allocate it among its members. This practice, of course, granted an instrument of considerable power to the associations, a factor which undoubtedly contributed to the prevalence of cartel-type agreements at the time when QRs were strongly effective.

ii. THE SCOPE OF THE SYSTEM OF QUANTITATIVE RESTRICTIONS

One ideal measure of the severity of a QR system is the amount of excess demand for each imported good at the controlled prices; or, more precisely, the proportion of total demand that remains unsatisfied. A second measure is the degree by which official prices underestimate the value of imports at prevailing quantities to actual or potential buyers. With demand elasticities varying over time (in temporal comparisons) or among goods (in cross-sectional comparisons), these two measures would not necessarily, of course, yield the same ordering in the system in measuring the severity of controls for each imported good, or the same answer in the analysis of developments over time. Both, however, are conceptually legitimate measures, and, when large differences or large changes in the degree of restrictiveness are involved, the differences in demand and supply elasticities become relatively less important and the two measurements would tend to yield similar results. Quantity measures are discussed in this section; price indicators are taken up in the next two sections.

The measurement of excess demand is, unfortunately, not feasible, and there is probably no reliable information anywhere on this point. Even if consumers or other potential buyers of imports were asked to estimate their shortages, the results would be unreliable. In any case, no such field survey has ever

been made in Israel. It has sometimes been suggested that the amount—size or value—of unsatisfied applications for import licenses could be used instead. But this measurement suffers from some serious flaws, even overlooking the immense practical difficulties in any attempt to collect data on such applications.[5] On the one hand, many applications for import licenses did not reflect any actual demand for imports. In a QR system, where it is well known from experience that a certain fraction of applications will get a negative response, importers are naturally motivated to apply for licenses for amounts larger than they actually need or intend to buy; this resulted, among other things, in the phenomenon that a significant fraction of import licenses was not utilized.[6] On the other hand, there is no doubt that some of the demand for imports was not reflected in requests for import licenses, since potential applicants for licenses may have decided that their applications stood no chance. When, for instance, licenses were in effect allocated by a trade or manufacturing association, trying to bypass this procedure in applying for an import license would be pointless. The competent authority would appear, in such cases, to grant practically all the import licenses for which it received applications, since applications would be restricted by the trade association to the total quota available.

Thus, there does not seem to be a feasible way of estimating excess demand for imports directly, or even by proxy. Instead, a few indirect indications will be mentioned, starting with data on the foreign-exchange budgets.

As I pointed out earlier, the data in Table 2-1 show, as a rule, an excess of foreign-exchange expenditures over the levels of planned expenditures and anticipated receipts. During the earlier part of the period covered, actual expenditures also usually exceeded actual foreign-exchange receipts. The budgetary year 1958–59 appears, on this score, to have been a turning point. From that year on, actual expenditures, while continuing to exceed planned expenditures—often by a substantial margin—always fell short of actual receipts, again often by a significant margin. The two gaps combined are one of the indications of the changing nature of the system of foreign-exchange controls. The acute shortage of foreign exchange seems to have disappeared in the late 1950s, and the system was not designed any longer to serve the major purpose of adjusting foreign-exchange expenditures—specifically on imports—to receipts. Indeed, by all available indications, the foreign-exchange budget ceased to play any serious role during the early 1960s; its discontinuation after 1964–65 was only a recognition of this fact.

Beginning in the late 1950s, the continuing system of administrative regulations was designed for purposes other than that of general adjustment of foreign-exchange flows. One such major purpose, which will be discussed later at greater length, was the protection of local industries from competing imports. Another purpose was the regulation of capital transfers. It should

be pointed out that during the later years, this meant not just prevention of capital outflows, but also regulation of capital inflows. In time, the government's objection to capital inflows strengthened, and regulations were made (although not always strictly adhered to) to prevent capital inflows of short duration and high interest rates. One source which was particularly discouraged was foreign suppliers' credit: the terms of the import license normally specified payment in cash, rather than on credit. One of the major motives of this rejection of foreign credit, besides the avoidance of interest payments (whether explicit or implicit in the terms of purchase on credit) was the fear of the effect of capital inflow on domestic liquidity. With a contractive domestic monetary policy and tightening credit conditions, importers (as well as banks or other domestic borrowers) tended to turn to credit from abroad. In Israel's circumstances—a country with a high ratio of imports to production and good access to foreign capital markets—unrestricted short-term capital inflows could thus defeat any contractive policy. Indeed, the possibility of abolishing foreign-exchange controls, which was contemplated on a number of occasions, most seriously right after the devaluation of February 1962, was rejected mainly on such grounds.

A similar indication, supporting (and to some extent repeating) the observation made on the basis of the foreign-exchange budget, is the movement of foreign-exchange reserves. The higher the reserves and the more they tend to increase, the less severe are restrictions expected to be. The position of Israel's external reserves is shown in Table 2-2.

This table shows that foreign-exchange reserves declined rapidly during 1949–51, and then remained close to zero during 1952 and 1953. In 1954 some reserves were re-established by a special operation,[7] but remained at a low level until 1958. From then on, Israel's external reserves rose markedly and almost without interruption for a whole decade—until the middle of 1968.

Another indication of the severity of restrictions may be found by asking what proportion of imports were in effect free, that is, suffered from no unsatisfied demand. Such a measure does not indicate the degree of severity of controls on imports which were *not* free; but it gives some idea of how important these unsatisfied amounts could be in relation to total imports. In an experimental study on this subject, Rom tried to answer this question by asking the persons in charge of each import item at the various competent authorities whether that item was *effectively* restricted or free.[8] Rom's study relates to a single period of time, and so throws no light on the development of the system over time. In addition, the method of inquiry could, at best, yield only tentative results. Yet, it is worth looking into the findings of the study, mainly for the impressions gained about the structure of the system.

Rom's study originated in an examination of the desirability of Israel's joining the Common Market (the European Economic Community) when it

TABLE 2-2

External Reserves,[a] End of Year, 1948–72

(dollars in millions)

Year	Reserves[a]	Rates of Change	Year	Reserves[a]	Rates of Change
1948	$141		1960	$ 270	60.7%
1949	117	−17.0%	1961	376	39.3
1950	66	−43.6	1962	506	34.6
1951	34	−48.5	1963	615	21.5
1952	31	−8.8	1964	643	4.6
1953	39	25.8	1965	748	16.3
1954	81	107.7	1966	756	1.1
1955	90	11.1	1967	968	28.0
1956	87	−3.3	1968	916	−5.4
1957	84	−3.4	1969	729	−20.4
1958	130	54.8	1970	849	16.5
1959	168	29.2	1971	1,278	50.5
			1972	2,134	67.0

SOURCE: For 1948–59, Michael Michaely, *Foreign Trade and Capital Imports in Israel* (Tel Aviv: Am Oved, 1953; in Hebrew). For 1960–72, *Statistical Abstract of Israel*, 1973, Table VII/6.

a. Gross reserves, including deposits abroad of commercial banks and of the government and foreign assets of the Bank of Israel.

was formed. Since joining the Market would have involved an Israeli liberalization, the aim of the study was to discover the goods which would not be affected because they were already either formally or effectively liberalized. The examination was concerned in principle with *private* imports only, and excluded import items handled mainly by the government. The proportions reported obviously related to total actual imports as influenced by restrictions, a fact which raises problems too well known to be dwelt upon here. Rom also asked officials at the competent authorities whether the liberalization of import items which were effectively controlled was "possible" if duties were levied on them. A negative answer to this question was most often based on the assumption that the duty required would be, according to the person asked, "too high." While all these are very crude estimates, based on personal judgments, they may provide a tentative indication of the relative severity of restrictions. On this basis, and with this limited and tentative interpretation, imports are divided, in Table 2-3, into three groups: effective liberalization, moderate restrictions, stringent restrictions.

TABLE 2-3

Effectiveness of Import Restrictions, 1956

(proportions of total value of imports)

Import Category	Formally or Effectively Liberalized	Moderately Restricted	Severely Restricted	Total
Foodstuffs and fodder	40%	4%	56%	100%
Raw materials	60	32	8	100
Finished goods	35	33	32	100
Total imports of goods	45	31	24	100

SOURCE: See accompanying text.

The indication provided by Table 2-3 is that close to half of total imports in 1956 were effectively liberalized, and roughly a quarter were subject to stringent restrictions. An earlier point must be emphasized here: these percentages are for the actual distribution of imports; weighting by shares of industries in local production, or by hypothetical imports in the absence of controls, would, of course, have resulted in a much higher degree of restriction. It should be further noted that 60 per cent of raw materials were liberalized, and that most other imports in this category were subject to only moderate restrictions; that is, by 1956, imports of raw materials were by and large not subject to severe controls, effective restrictions being mainly confined to other categories of imports. Note also that the category of foodstuffs and fodder, in contrast to the other two categories, was characterized by either full liberalization or severe restriction. This impression is compatible with the views prevailing at that time, which tended to classify imports of foodstuffs as either "essential" and to be imported relatively freely or as "luxuries" and to be discouraged. Data on effective exchange rates, which will be studied later, also show a similar concentration of imports of this category at the extreme ends of our classification.

iii. THE "IMPORTS-WITHOUT-PAYMENT" MARKET

A very interesting feature of the QR system in its earlier years was the institution known as the "imports-without-payment" (IWP) market.[9] It was the most important attempt during the early 1950s to establish or regulate a private foreign-exchange market parallel to the official one.

Supply in the IWP market originated from three acknowledged sources: foreign capital transfers, immigrants' capital, and gifts from abroad.[10] At the

end of 1948 the government allowed foreign investors to transfer their capital in the form of goods from a specified list, on condition that foreign exchange amounting to 30 per cent of the import license be sold to the Treasury at the official rate. In effect, import licenses thus issued became, to a large extent, marketable, although not in a sanctioned market. In July 1949, both the list of categories exempt from the obligation of selling to the Treasury and the list of goods which could be imported were extended. Most of the imported goods allowed were "nonessential." This, plus a steep rise in the black-market rate of foreign exchange, led the government to reverse course. In December 1949 and January 1950 new regulations were issued, narrowing the list of permitted imports and prohibiting transfer of the right to import (by no longer permitting an Israeli importer to deposit money in the restricted account of a foreign investor). Likewise, in April 1950, IWPs from the United States and Canada were disallowed altogether, although a few large transactions did receive ad hoc permission. The level of imports covered by these regulations fell considerably thereafter. This, together with rapidly mounting shortages, led the government to reverse course once more.

In October 1950, this reversal and the regulations which followed during the next two months led to what may be viewed as the classic form of imports without payment, in which imports were made accessible to the original owners of foreign capital as well as to Israeli residents; that is, transferability of the right to import became legal. The Israeli importer became free to buy foreign exchange from the transferer of capital at a rate determined by the partners to the transaction. Import items eligible under this scheme were determined by the government, and embraced nonessential as well as essential goods. If imports belonged to the former category, foreign currency at a specified proportion of the value of the import license was to be submitted to the Treasury at the formal rate of exchange; imports of essential goods were exempt from this obligation. In effect, the government allocated licenses for "imports without payment" during this period in the following way: 70 per cent were allocated for the importation of construction materials; 20 per cent, for importation of rubber tires; and 10 per cent, for other essential goods, mainly construction materials for schools and hospitals. Licensees in the first category were required to sell half the foreign exchange they bought in the IWP market to the Treasury at the formal rate of exchange, using the other half to finance their imports. The other two groups of licensees were exempt from the currency-selling requirement.

Within a few months the policy was changed again. The rate of exchange in the IWP market rose rapidly along with the black-market rate. This led the government to intervene in the market by establishing a consortium of importers, which became the only agent entitled to buy foreign exchange in the market. Under terms of a regulation issued in April 1951, the rate of

exchange for these transactions was determined by the Treasury. The latter first stabilized the existing rate and then actually lowered it. Initially, this had little effect on the size of the market. But within a few months, the disparity between the black-market rate, which was rising sharply, and the rate in the IWP market became wide enough for the supply of foreign exchange in the latter market to fall drastically. In the latter half of 1951, the IWP market therefore came to be confined again, in the main, to various transactions approved ad hoc by the government.

"Imports without payment" originated in response to a number of circumstances, and were intended to satisfy several governmental goals. The latter were not always consistent, and the inconsistency (as well as changes in circumstances) contributed to the many fluctuations in the nature and operation of the market. Basically, the conflict was between two objectives. On the one hand, the government wanted to use the IWP market as a vehicle for encouraging various kinds of capital inflows by giving them a premium over the official exchange rate. This was accomplished by using these capital imports for the importation of goods that commanded high domestic prices: the premium involved would be the excess of the prevailing domestic price over that yielded by the official rate of exchange (allowing for transportation, marketing, etc.). Reaching this target thus called for high premiums and, hence, importation of goods with high local prices. Another objective of the government, leading in the same direction, was to provide an outlet for spending some of the involuntary accumulation of money by making available some goods not provided by the controlled market. On the other hand, the government was particularly anxious to increase imports of "essential" goods, which were usually subject to low ceiling prices. In addition, the government was reluctant to let effective exchange rates in the IWP market rise very high, lest the credibility of the official rate be impaired.

After the formal devaluation of February 1952, no attempt was made to reestablish a regulated IWP market. From then on these imports consisted to an increasing extent of gifts, bona fide or otherwise. The market for gifts of food packages became increasingly organized, and much of the capital transfer to the country was illegally channeled through this market. Instead of transmitting actual parcels of food prepaid abroad, a few companies were established that provided food items to local recipients in exchange for scrip certificates which were paid for abroad (mainly in the United States). Within a short time these certificates became transferable, first illegally and then, after bearer certificates were allowed, in effect with official approval. The scrip companies were entitled to import food, having committed themselves to transfer a given proportion (42.5 per cent) of their foreign-exchange proceeds at the formal rate to finance local purchases of food, a commitment which was not strictly observed. During 1955 the scrip arrangements were abolished

and the IWP market lost its importance as a channel of imports except for imports in kind by immigrants or through bona fide gifts, which, of course, went on. The size of the IWP category during its years of significance is shown in Table 2-4.

TABLE 2-4
Imports Without Payment, 1949–54

	1949	1950	1951	1952	1953	1954
Total imports of goods (millions of dollars)	253.1	302.0	383.7	324.1	282.1	290.3
Imports without payment (millions of dollars)	38.6	51.2	71.3	65.1	59.8	42.7
Source of financing of imports without payment (per cent):	100.0	100.0	100.0	100.0	100.0	100.0
Capital transfers	42.8	40.9	44.3	44.7	40.2	22.5
Immigrants' transfers	39.5	29.1	17.0	14.6	5.0	3.6
Gifts	17.7	30.0	38.7	40.7	34.8	48.8
Other	—	—	—	—	20.0	25.1

SOURCE: Michael Michaely, *Israel's Foreign Exchange Rate System* (Jerusalem: Falk Institute, 1971; in English), Table 2-3.

For most of the period, data on prices paid in the IWP market are scarce. In studies of that period it is mentioned that during the first half of 1949, when IWP licenses were in effect largely transferable, they were sold to importers at a price ranging from 20 to 25 per cent of the import value. Since the importer at that time was obliged to sell foreign exchange equivalent to 30 per cent of the import value to the Treasury at the formal rate and presumably bought the currency in the black market, at a rate which was about 25 per cent above parity at that time, this price meant a premium of over 30 per cent for the import license. This seems to be a rather modest premium.[11] Later data show a rapidly growing disparity (see Table 2-5).

The observations in Table 2-5 for 1949 and 1950 may be viewed as illustrative, tentative samples. The data for 1951, on the other hand, are complete and precise: they refer to the uniform, publicized rate that applied in the organized market at that time. Special attention should be paid to the period of January–March 1951, during which the rate of exchange in the IWP market was completely free.[12] During that period the implied rate of exchange for imports of construction material [13] was about six times the formal rate of exchange. This ratio is quite close, as will soon be seen, to the size of disparities between free and official prices of foodstuffs, as well as those of other

TABLE 2-5

Foreign-Exchange Rates in the Imports-Without-Payment (IWP) Market, 1949–51

Period	Exchange Rate in IWP Market (IL per $) (1)	Implied Exchange Rate for Imports of Construction Materials[a] (IL per $) (2)	Ratio of Col. 1 to Formal Rate[b] (3)	Ratio of Col. 2 to Formal Rate[b] (4)
1949: October–November	.446–.500	—	1.3–1.5	—
December	.666–.900	—	1.9–2.5	—
1950: April	.625–.645	—	1.7–1.8	—
1951: January	1.250	2.143	3.5	6.0
February–March	1.300	2.243	3.6	6.3
April	1.100	1.843	3.1	5.2
May–June	0.990	1.623	2.8	4.5
July–December	0.930	1.503	2.6	4.2

SOURCE: Based on Michaely, *Foreign Exchange System*, Table 2-4.

a. It will be recalled that an importer of construction materials had to surrender to the Treasury, at the formal rate, half of the foreign exchange bought by him in the imports-without-payment market. If r_o is the formal rate, r_s the rate in the imports-without-payment market, r_i the implied rate for construction materials, and p the fraction surrendered to the Treasury, then $r_i = (r_s - pr_o)/(1 - p)$; if $r_o = 0.357$, and $p = 0.5$, then $r_i = 2r_s - 0.357$.

b. The formal rate of exchange was IL 0.333 per dollar until November 1949, and IL 0.357 per dollar from then on until February 1952.

goods, during this period. This similarity may be assumed to be even closer for later periods, for which direct information about the market rate is not available. It will be recalled that from 1952 to 1954 the scrip certificates were the main instrument of the semiorganized IWP market. Purchases by scrip arrangements were apparently the main source of supply of foodstuffs in the black market at that time. With a considerable degree of perfection and arbitrage in the markets, it may be presumed that the foreign-exchange rate implied by the price of the scrip certificates was related to the formal rate of exchange in about the same ratio as between free-market and official food prices.

iv. PRICES IN OTHER "BLACK" AND FREE MARKETS

The IWP market yielded some price data by which the severity of the QR system can be inferred. This is, of course, rather fragmentary evidence. While

no data are available to provide a full measure of the severity of controls, as would be reflected by the gap between actual and demand prices for the imports allowed by the system's quotas, a few other fragments may be found which taken together serve as additional indicators. These are prices paid outside the control system—either legally where free markets existed in addition to the controlled, rationed markets, or illegally in black markets, or in the so-called grey markets where transactions were made at freely determined prices without official sanction but presumably with the knowledge of the government.

At the peak of the control system, during the early 1950s, entirely free markets were few and mainly confined to services. Imports, or goods with a high import content, were almost universally rationed and subject to price ceilings, the most important exception once more being imports made under the IWP plan. Noncontrolled prices were thus usually prices paid in black markets. While it was a matter of common knowledge that these markets were widespread, and that prices paid in them were far above the official prices, actual data about black-market commodity prices are quite scarce. Aside from wanting to avoid the difficulty involved in collecting price data in unorganized, widely fluctuating, and illegal markets, the government was reluctant to encourage the collection of such data, because its doing so might have been interpreted as giving some legal sanction to these transactions. Furthermore, by governmental direction, the Central Bureau of Statistics based cost-of-living index calculations only on official prices. It was reluctant to investigate black-market prices, or even the few free legal prices that existed alongside the (lower) official prices. This inhibition was due to the attempt to keep the cost-of-living index from rising (and even, during part of the period, to lower it), mainly in order to mitigate pressure for wage increases.

By way of exception, the Central Bureau of Statistics did collect free-market data on food prices; these were not published or publicized at the time but were made available for later investigations. In one study, these data were used to construct an index of free-market food prices for comparison with the index of official prices.[14] Since these indexes exclude fruits and vegetables from the food category, the remaining food items include (particularly in earlier years) a very high import component—certainly much over 50 per cent on the average—and are, therefore, relevant in the present examination. The results, presented in Table 2-6, are quite revealing and clearly indicate the developments over the period.

For several years controls grew increasingly severe. They reached a peak in 1951, when free-market prices were seven times higher than official ceiling prices.[15] Beginning in the first half of 1952 the severity of controls declined consistently and rapidly, a movement clearly associated with official price trends, which will be surveyed later in this chapter. This downward movement

TABLE 2-6

Ratio of Free-Market to Official Prices of Food, 1949–58

(half-yearly averages)

Period		Ratio	Period		Ratio
1949	First half	3.1	1954	First half	2.7
	Second half	4.2		Second half	2.9
1950	First half	5.3	1955	First half	2.5
	Second half	6.1		Second half	2.6
1951	First half	7.0	1956	First half	2.5
	Second half	6.8		Second half	1.6
1952	First half	6.1	1957	First half	1.8
	Second half	5.2		Second half	1.5
1953	First half	3.9	1958	First half	1.5
	Second half	2.9		Second half	1.7

SOURCE: Compiled from data in Yoram Weiss, "Price Control in Israel, 1939–1963" (M.A. diss., Hebrew University, 1964; in Hebrew), Table C-1. Weiss used estimates of family expenditures as weights in his index of free-market prices. The indices include sixteen food items.

became very slight from the second half of 1953 to the first half of 1956, a period in which the severity of controls seems to have been virtually stable at a level substantially lower than during the early 1950s but still significant. In the second half of 1956, the severity of controls, as measured by the ratio in Table 2-6, declined perceptibly. The excess of free-market over official prices was only about 50 to 70 per cent from then on, indicating a system of controls of limited "bite" by comparison with the system of the early 1950s.

It is interesting to compare the relationship of these price indicators to indicators of quantities. Again, actual estimates of quantities of excess demand in the controlled markets are obviously not available. Table 2-7 shows the proportion to all food expenditures of expenditures for foods subject to ceiling-price regulations and rationing. These data (available only on a yearly basis) show the same movements as those of Table 2-6, and the association of the two could hardly be a coincidence.[16] The severity of controls must have increased until 1951, and then decreased because of changes both in the number of items controlled and in the strictness of the regulations affecting them, and the two components were probably closely correlated.

The series for food prices, just discussed, is apparently the most complete and organized set of data available on free-market prices of goods. Other pieces of information are only casual examples a few of which are presented in Table 2-8. The first two sections of the table show results quite similar to

TABLE 2-7

Controlled Food Items as a Proportion of Total Food Expenditures, 1948–59

Year	Proportion	Year	Proportion
1948	15.6%	1954	69.0%
1949	62.1	1955	67.1
1950	89.7	1956	55.7
1951	94.6	1957	47.9
1952	89.4	1958	43.0
1953	80.8	1959	21.6

SOURCE: Weiss, "Price Control," Table C-4.

those derived from the data on food prices. Free-market prices were much higher than official prices, generally three to ten times as high. Also, although these two parts are not strictly comparable, it appears that the disparity between the two prices grew between September 1950 and January 1951, as indicated particularly by the free-market price movement of certain construction materials; this again agrees with the indication provided by food prices. The data in the third part of Table 2-8 also show a substantial disparity between free-market and official prices; but it is considerably lower than in the earlier series, ranging only between 1.4 and 2.5. In part, this is probably a reflection of the general movement toward reduced disparity, which started early in 1952 with major boosts of official prices. But it may well be that in the clothing industry, to which the data of this part of the table refer, the excess of free-market over official prices was indeed generally lower than in categories such as food or construction materials.[17]

Finally, a most interesting price for the purpose at hand is the black-market rate of foreign exchange. In principle, this price does not necessarily reflect price disparities in the import of goods. Foreign exchange might be bought in the black market not in order to finance current purchases, but as an asset to be held for some length of time, either for its direct yield or in anticipation of a future rise of the black-market rate itself or of the local price of imported goods and services which the foreign exchange could buy.[18] Indeed, in later years, when the scope of the foreign-exchange black market was small, much of the demand in this market was most likely due to such motivation.[19] In the earlier years, on the other hand, most of the foreign exchange bought in the black market was probably intended for the purchase of imports of goods and services. The IWP market discussed above was probably the most important channel for imports of goods. When the black-market rate is compared with estimates of the IWP rate, for periods when the latter was uni-

TABLE 2-8

Free-Market Versus Official Prices, Specified Dates, 1950–52
(prices in Israeli pounds per unit)

Commodity	Official Price (1)	Free Price (2)	Ratio of (2) to (1) (3)
	September 1950		
Plywood (m^3)	110.0	330.0	3.0
Soft wood (m^3)	22.5	70.0	3.1
Construction iron (ton)	55.0	500.0	9.1
Cement (ton)	10.0	25.0	2.5
Wool, locally woven (m)	2.8	10.0	3.6
Wool, English (m)	4.5	20.0	4.4
	January 1951		
Cotton thread (kg.)	1.05	6.00	5.7
Wool thread (kg.)	2.00	20.00	10.0
Wool yarn (m)	5.00	10.00	2.0
Linen, low quality (m)	0.26	1.30	5.0
Linen, high quality (m)	0.78	2.50	3.2
Cement (ton)	11.00	85.00	7.7
Construction iron (ton)	100.00	500.00	5.0
Soft wood (m^3)	33.00	160.00	4.8
Pipes, 1/2 in. (m)	0.15	0.95	6.3
Glass (m^2)	0.60	5.00	8.3
	August 1952		
Men's wool suit (pr.)	45.00	100.00	2.2
Wool "utility" trousers (pr.)	17.00	35.00	2.1
Men's underwear (pr.)	0.51	1.25	2.5
Nylon stockings (pr.)	1.75	3.00	1.7
Silk (unit not specified)	3.00	5.00	1.7
Men's pajamas (pr.)	10.36	23.75	2.3
Sheet	3.27	8.00	2.4
Bath towel	0.73	1.50	2.1
Diaper	0.66	1.50	2.3
Men's shoes (pr.)	10.05	15.00	1.5
Women's shoes (pr.)	8.34	12.00	1.4

m = meter. m^3 = cubic meter.
m^2 = square meter. kg = kilogram.

SOURCE: September 1950 and January 1951—Weiss, "Price Control," Table C-16 (based on newspaper reports); August 1952—internal memorandum of the Ministry of Finance approximately September 1953.

form and freely determined in the market, the two rates are indeed found to be very similar (although the number of such observations is rather small). It may thus be presumed that for the first few years, black-market foreign-exchange rates reflect quite well the excess of free-market prices over official prices. The black market for foreign exchange was always well organized, with rather uniform rates prevailing.[20] The black-market rate was, therefore, well known and well publicized.

The impression gained from the quarterly data on exchange rates in Table 2-9 is quite strong and rather similar to that conveyed by the other pieces of evidence presented previously. The ratio of the black-market to the formal rate was at first, in 1949, only slightly above unity, and was rising only slowly. But in 1950, and even more significantly in 1951, the disparity between the two rates grew rapidly and very substantially. At the peak in late 1951 the black-market rate was roughly seven times that of the formal rate—a ratio quite similar to the disparity shown earlier between free-market and official food prices as well as to disparities in prices of other goods. For a number of years beginning in early 1952, the black-market rate was roughly stable, while the formal rate climbed steadily. The disparity between the two thus went down, gradually but considerably, until in 1955 it again reached the same low level as in 1949. From then on, the black-market rate rarely exceeded the formal rate by more than 20 to 30 per cent.[21] Considering the other sources of demand for foreign exchange in the black market—mainly for speculation—this small disparity probably indicates that only a small portion of demand at the existing formal rates (combined, of course, with the effect of tariffs and similar levies on imports) was left unsatisfied by the government's allocation mechanism.

v. THE POLICY SHIFT: FROM QUANTITATIVE RESTRICTIONS TO USE OF THE PRICE MECHANISM

All the available indications thus show the same time pattern: a system of quantitative restrictions growing in severity in 1949 and the early 1950s, and reaching a peak in late 1951 and early 1952, when QRs, as measured by the gap between official and free-market prices, were very severe indeed. Beginning early in 1952, this trend started to reverse itself, until by about 1956 the system of QRs had almost been ended as an instrument for regulating total imports and keeping them substantially lower than they would have been otherwise.

The changing nature and intensity of the QR system could conceivably be explained by accidental circumstances, such as the appearance and dis-

appearance of sources of capital imports. To some extent, it might have been so, but there seems to be little doubt that the pattern of development of the QR system is to be viewed primarily as a change in *policy;* it is one side of a coin, the other side of which was a switch (to which occasional references have

TABLE 2-9

Black-Market Rate of Foreign Exchange, Quarterly, 1949–56

(Israeli pounds per dollar)

Period[a]	Black-Market Rate (1)	Formal Rate (2)	Ratio of (1) to (2) (3)
1949: I	0.379		1.1
II	0.425	0.333	1.3
III	0.419		1.3
1949: IV	0.498		1.4
1950: I	0.573		1.6
II	0.635		1.8
III	0.748		2.1
IV	0.862	0.357	2.4
1951: I	1.349		3.8
II	1.221		3.4
III	1.183		3.3
IV	2.402		6.7
1952: I	2.583	0.460	5.6
II	2.663	0.700	3.8
III	2.544	0.800	3.2
IV	2.240	0.790	2.8
1953: I	2.511	0.770	3.3
II	2.400	0.800	3.0
III	2.314	0.880	2.6
IV	2.442	0.890	2.7
1954: I	2.763	1.240	2.2
II	2.613	1.420	1.8
III	2.553	1.680	1.5
IV	2.495	1.710	1.4
1955: I	2.300		1.3
II	2.225		1.2
III	2.263		1.2
IV	2.423	1.800	1.3
1956: I	2.407		1.3
II	2.379		1.3
III	2.476		1.4
IV	2.748		1.5

Notes to Table 2-9.

SOURCE:

Col. 1—For 1949I, 1949II, and 1952III, Don Patinkin, *The Israel Economy: The First Decade* (Jerusalem: Falk Project for Economic Research, 1959; in English), App. B; data for other years compiled from *Statistical Abstract of Israel*, 1955–56 and 1957–58.

Col. 2—Michael Michaely, *Israel's Foreign Exchange Rate System*, Part II, *Tables* (Jerusalem: Falk Project for Economic Research, 1968; in Hebrew).

a. For 1949I, 1949II, 1952III, and 1952IV, the black-market rate is for the end of the quarter; other black-market data are quarterly averages of end-of-month rates. Formal rates are quarterly averages weighted by size of imports.

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been made) to reliance on the price mechanism for regulating the balance of payments. A detailed description and analysis of this change will be presented in Chapter 5. Here it will be only briefly outlined.

From the establishment of the state of Israel until early 1952, the effective price of foreign exchange in the import trade was almost constant. Aside from a slight increase of a few percentage points in the formal rate in September 1949, no formal devaluation was undertaken. Customs duties and other levies on imports also changed very little during these years. Thus, the effective rate of exchange with the dollar in the import trade, which includes these duties, changed between 1949 and 1951 (yearly averages) from IL 0.386 to IL 0.395 per dollar—an increase of just about 2 per cent. The stability of the rate was probably due to the notion prevailing in the government at that time that cheap imports were essential to maintain a minimum standard of living for all segments of the population and to keep the general price level stable—a purpose which came to be regarded as a target in itself.

The policy switch occurred in early 1952, and the execution of the new policy took close to three years. On February 14, 1952, the New Economic Policy was announced—a name fully justified by the events. The essence of this policy was a process of progressive devaluation, accompanied by a parallel increase of domestic (controlled) prices and undertaken within a context of restrictive demand policy. A multiple exchange rate system was introduced, and the average rate kept rising by the shifting of transactions from lower to higher rates. While the formal rate on the eve of this process was IL 0.357 per dollar, by its end, around mid-1954, almost all transactions were conducted at a rate of IL 1.800 per dollar. The formal rate thus increased about fivefold within this period. At the same time, import duties and other levies were also raised; these actions contributed to the increase in the effective rate of exchange, although the contribution was minor by comparison with that of the formal devaluation. The effective rate of exchange in import transactions thus increased, from 1951 to the end of 1954, by about 450 per cent. From then on until the devaluation of 1962, changes in the effective exchange rates, which were introduced only through changes in import duties or in ex-

port subsidies, were very moderate—on the average, just a few percentage points per year.

The recorded increase in domestic prices, which reflects primarily changes in controlled (legal) prices, was also very substantial: from 1951 to 1953 this price level about doubled, and it further increased by some 10 per cent from 1953 to 1954. The "true" price level increased substantially less: free-market (or black-market) prices not only failed to rise to the same extent as did official prices, but sometimes they actually declined. But even in comparison with official prices—though they closely reflect changes in import prices, introduced primarily through changes in the exchange rate—the relative level of the rate of exchange (PLD-EER)[22] increased substantially during the period of progressive devaluation. From 1951 to 1955 the PLD-EER increased by about 170 per cent—an average annual (compounded) rise of close to 30 per cent.

The substantial rise in the relative level of the exchange rate—and, through it, of the level of import prices in relation to domestic prices—would be expected to lead to a reduction of demand for imports. This indeed appears to have happened on a very large scale; and, although any statistical inference based on simple comparisons of various time series must be regarded as suggestive rather than firmly conclusive, the chronological association of the series in this instance is too striking to be dismissed as accidental. Imports actually declined after 1951, measured at constant prices, and only in 1955 did they again reach the 1951 level. In proportion to GNP, the decline of imports during these years was striking—from over 52 per cent in 1951 to 33 per cent in 1954.[23]

The decline in imports during 1952–54 is all the more spectacular when considered in conjunction with the development of the QR system. It has been shown that after the first half of 1952 the degree of severity of the controls declined rapidly. The very bold use of the price mechanism, by which relative prices of imports were almost tripled, thus led to the simultaneous achievement of two purposes: the reduction in the size of imports (in relation to the level of the national product); and the scrapping of QRs as a major policy instrument for the regulation of imports. Altogether, the New Economic Policy of 1952–54 and related developments may be considered an outstanding example of the substitution of the price mechanism for regulation through quantitative restrictions.

vi. LIBERALIZATION AND THE NATURE OF THE REMAINING QRs

By the mid-1950s, then, the QR system no longer served as a major instrument of balance-of-payments correction. In late 1956 and early 1957, follow-

ing the near exhaustion of external reserves due to the cost of the Sinai campaign of October 1956 and the economic sanctions imposed by the United States government, the reimposition of more stringent controls was extensively debated within the government, but finally rejected. From then on the use of this instrument was not seriously contemplated, although during episodes of particularly strong balance-of-payments pressure it has occasionally been advocated in the press or by individual government officials.

The relaxation of restrictions was, however, not uniform: it applied mostly to raw materials and, to a smaller extent, to finished investment goods, rather than to finished consumer goods. This pattern of liberalization was indicated by the data in Table 2-3. It is also supported by the data in Table 2-10, which show the changing structure of imports during the late 1950s. The

TABLE 2-10

Distribution of Main Categories of Imports, 1951–59

	1951	1952	1953	1954	1955	1956	1957	1958	1959
Value (millions of dollars)									
Final consumer goods	87.6	73.3	59.1	49.1	50.4	50.1	50.0	53.1	42.7
Raw materials	127.0	118.7	127.4	150.6	173.0	181.9	211.3	211.8	233.0
Investment goods	100.4	91.4	64.9	64.3	76.7	101.5	116.1	112.2	112.2
Fuel	31.9	40.3	31.3	31.4	33.0	32.9	53.9	40.4	34.7
Total	346.9	323.7	282.7	296.0	333.6	367.0	432.0	417.9	423.1
Percentage of total imports									
Final consumer goods	25.3	22.6	20.9	16.6	15.1	13.7	11.6	12.7	10.1
Raw materials	36.6	36.7	45.1	51.0	51.9	49.6	49.0	50.7	55.1
Investment goods	28.9	28.2	22.9	21.8	23.0	27.7	26.9	26.9	26.5
Fuel	9.2	12.4	11.1	10.6	10.0	9.0	12.5	9.7	8.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Michaely, *Foreign Trade*, Table 28.

decline in the share of finished consumer goods and the rise in the share of raw materials can be clearly seen: the former category declined over the period from about one-quarter of total imports to less than half of this fraction, while the latter increased from over a third to over a half of the total. Put differently, imports of final consumer goods declined over the period in absolute (dollar) terms, and very markedly so in relation to national income, while imports of raw materials almost doubled in absolute terms, rising at approximately the same rate as the national income and product. This change in the composition of imports might conceivably have been due to other fac-

tors, particularly to relative price movements. However, data presented later in this study, on sectoral movements in exchange rates, do not support this hypothesis. Higher elasticities of demand for imports of consumer goods than for other imports, which again will be indicated later in this study, do probably provide a partial explanation for the decline in the share of final consumer goods. But this decline was so substantial during this period that it must in all probability reflect the concentration of quantitative restrictions in this sector.

Liberalization of imports of raw materials was carried out gradually, without specific policy declarations, by increasing the ratio of allowed imports to total import applications. Accompanying the rise of this ratio were accommodating changes in the administration of the system, such as a gradual shift from ad hoc grants of specific import licenses for each individual shipment to general import licenses. The only liberalization explicitly announced during the 1950s took place in early 1956 and involved the importation of a few major raw materials, such as lumber and hides and leather. These imports were declared unrestricted, although the government still retained the right to dictate the source of purchase. In practice, this meant that the government could direct the importer, when this seemed feasible, to buy from one of the countries with which Israel had at that time a trade surplus under a bilateral clearing agreement. At the same time—and this was a specific example of the replacement of QRs by the price mechanism—special levies were imposed on these liberalized imports.

By 1957, most imports of raw materials were, in effect, liberalized. The nonliberalized items belonged mainly to two categories. One, quite substantial in size, consisted of raw materials for the food industry. Imports of these goods were concentrated largely (about 70 to 80 per cent) in the hands of the government, and private imports of items purchased by the government were not allowed at all. This practice started during World War II, when food imports were handled by the British Middle-Eastern Supply Center in Cairo. For several reasons, the practice has to a large extent continued to this day, although the list of governmental import items has narrowed down. One reason for its continuance is a belief that the government, as a single purchaser, would do better than private traders in these import markets, due to the value of its monopsonistic position. Likewise, local consumers of these essential goods would be better protected from monopolistic exploitation if the government were the seller of the import in the local market—by virtue of which role, the government also regulates the price of the final product (such as bread, edible oil, or sugar). A further alleged consideration is that the government must maintain substantial stockpiles of foods for emergencies. For largely similar reasons, the government has also always been the sole importer of fuel oil, which is the largest single import item. By the second half of the

1950s, the handling of imports by the government was exclusively due to such reasons and had almost no connection with the general balance-of-payments situation: excess demand for these raw materials in the local market was the exception, rather than the rule.

The other category of nonliberalized imports of raw materials may be characterized not by the nature of the goods but by the motivation for restrictions, which are found not on the import but on the export side. As will be explained in Chapter 4, during most of the 1950s, a principal means of encouraging exports was the linking of the right to an import license for raw materials to production for export. In order for this system to be in any way influential, such imports must have involved quota profits. Although the generation of such profits was not an original purpose of the imposition of restrictions, it quite often was the reason for not removing effective restrictions on the raw materials involved. During the late 1950s and early 1960s, restrictions motivated by this purpose mostly disappeared, although it is not entirely clear whether imports were liberalized because the linkage of imports to exports was discontinued as an export policy, or whether the policy was discontinued since the spreading of liberalization of imports of raw materials made it ineffective; quite possibly, it was a double-edged movement in this direction.

By the mid-1950s, therefore, imports of raw materials were largely liberalized, and by the early 1960s this liberalization—in the sense of an absence of excess demand at existing prices—was almost complete. This was by no means the case, however, with other imports. Imports of final goods, particularly final consumer goods, were restricted very effectively, and importation of many items was prohibited. These restrictions were due not to balance-of-payments considerations, but to the policy of protecting import-competing domestic industries. Consequently, this policy also applied to imports of certain raw materials which competed with local production, although these imports were not very sizable.

From the very beginning of the operation of foreign-exchange controls and the QR system, the general directive given to the competent authorities was to prohibit any imports of goods which were produced domestically. A declaration by a local manufacturer to the Ministry of Commerce and Industry that he was producing a given item was usually sufficient basis for the ministry to prohibit imports of that item. During the 1950s a public commission "for the protection of local industries," which was associated with the ministry, operated with the announced purpose of deciding on requests for protection. In effect, it served exactly the opposite purpose: since protection by total import prohibition was afforded almost automatically, the commission handled applications of importers who argued that in their specific cases, imports should be allowed even though they competed with existing local pro-

duction. The commission was willing to consider such applications on the grounds that local production did not meet necessary quality specifications; that it could not be provided on time; or that its prices were excessive. The commission had a rule for deciding upon the last ground: a gap of over 50 per cent between the local and the foreign price was declared to be excessive.[24] If the good concerned was an input to an export good, a gap of over 25 per cent was considered as the limit. Later, in 1958, an advisory council recommended changing this rule so as to grant local production which competed with imports an *effective* protection rate equal to the premium rate given to value added in exports (at that time, roughly 50 to 60 per cent) *plus* an additional rate that would vary according to the type of good—from a minimum of 15 per cent for raw materials to a maximum of 40 per cent for finished consumer goods.[25] In effect, however, these rules were far from serving as operational policy directives. Decisions were made ad hoc, and occasions on which imports were allowed because local prices were found to be excessive were rare indeed.[26]

The policy of total protection by import prohibition was comprehensive in its application to final consumer goods. With respect to raw materials and investment goods, on the other hand, the principle of protection of local industry could not lead to a clear-cut policy, since the protection of one local industry in these categories was necessarily at the expense of other industries using the raw materials or the machines and tools. Most raw materials could not, in any case, be replaced by local production or a local substitute within a relevant price range. Of those which could, some indeed became subject to import prohibition or restriction, although each case, facing strong opposition, was decided only after much discussion rather than in an automatic fashion; raw materials for the plastics industry are a case in point. Most investment goods, too, particularly imports of heavy industrial equipment, could not, during the 1950s, be feasibly replaced by local products; yet many goods, such as tools or replacement parts, could technically be produced locally. In these instances no automatic protection was granted. Although reliable quantitative estimates are not available, the general impression gained from students of Israel's industry and officials administrating the machinery is that, as a rule, the policy was *not* to protect such local industries by import prohibition. This impression is also borne out by data on effective exchange rates, presented later in this analysis.

On the whole, then, it seems that a clear distinction among categories can be made: protection of industries producing final consumer goods by import prohibition was comprehensive and almost universal; protection of industries producing raw materials and investment goods was sporadic, and probably applied only to the minority of instances in which local production was technically feasible.

vii. GEOGRAPHIC DISCRIMINATION

On the whole, geographic discrimination was never a very important trait of Israel's import policy and of the system of quantitative restrictions. When the QR system was at its peak, during the late 1940s and early 1950s, there was only a minor attempt at governmental restriction of the source of purchase (although, technically, each import license designated the currency of payment and the country of supply, and was not valid for purchases under other circumstances). The reason for this surprising largess was a *relative* abundance, even at that period, of "hard" currencies. Exports in these years covered only a small fraction of imports, which were mainly financed by capital transfers. The latter, in turn, comprised mostly convertible or, at least, semiconvertible currencies. At the beginning, one important source of capital imports was the relatively large frozen sterling reserve (over $100 million), which was freed for use in early 1950 by agreement with the British government and was mostly exhausted during the following two years. Although sterling was not then a perfectly convertible currency, its convertibility within a wide area—in addition to the potential importance of the United Kingdom itself as a source of supply in a free world market—was sufficient to insure that the importer was not normally hampered by having to pay in sterling.

More important over most of the period were capital transfers from the United States, by way of loans and grants from the U.S. government and American Jewry. The dollars received were partly used to finance import surpluses from other countries, where the specific imports required (or allowed) were cheaper. Later, beginning in 1953, reparations payments from the German government became one of the major sources of capital imports. By the reparations agreement, purchases financed from this source were confined (except from a certain fraction used to pay the United Kingdom for oil imports) to German goods in agreed-upon categories. While the goods purchased in this way were not normally more expensive in Germany than elsewhere, the restriction on the use of these funds certainly led to some shift in the commodity composition of imports, although this effect diminished with the years. Beginning in 1954, German restitution payments to individuals were added as still another major source of capital imports. Except during a very short period at the beginning, these payments were made in a currency which was convertible for most practical purposes. All in all, the availability of convertible capital transfers obviated the need for any extensive geographic redirection of the import trade by the government.

Paradoxically, significant geographic discrimination started only in 1953, when the general restrictiveness of the system was already rapidly diminishing. This discrimination clearly originated on the export side. In those years, as

some capacity for industrial exports developed, it was assumed that such exports would flow provided there was access to protected foreign markets, the instrument for protection being bilateral trade and payments agreements. Consequently, Israel entered into a number of such agreements, in which the partner country was to purchase from Israel mainly industrial products while Israel would buy in exchange mainly foodstuffs and raw materials. The most important partner country to such an agreement was Turkey, with Yugoslavia coming next. Stated in terms of convertible currencies, Israel's imports from these countries were clearly more expensive than similar goods in the free world market. Obviously, each of the partners to such an agreement tried to sell to the other its most expensive goods and to exclude exports which could compete freely in convertible-currency markets. Although Israel used a specific price mechanism designed to compensate importers for these price differences, as will be pointed out later in this study, this mechanism in itself was quite often inadequate; so the government resorted to the QR system as a means of directing Israel's import trade toward its partner countries.[27]

The share of Israel's trade within the framework of payments agreements in the country's total trade during the 1950s is shown in Table 2-11. The bilateral trade flows with each partner country were roughly in balance most of the time, since autonomous capital transfers from these countries were relatively unimportant. (And since, of course, neither Israel's nor the other partner's currency was convertible, trade surpluses would be something of a waste.) In Israel's over-all trade, imports were several times

TABLE 2-11

Share of Exports and Imports of Goods Under Bilateral Payments Agreements, 1950–59
(percentages of total exports or imports)

Year	Exports	Imports
1950	16.2	6.8
1951	18.3	8.9
1952	18.0	8.1
1953	39.7	13.5
1954	40.5	18.3
1955	40.7	18.6
1956	33.0	17.6
1957	31.4	12.5
1958	23.8	15.0
1959	18.7	14.5

SOURCE: Michaely, *Foreign Trade*, Table 47.

the size of exports; therefore, trade under payments agreements made up a much larger share of Israel's exports than its imports. During the years 1953–55, which appear as the peak period for trade under payments agreements, exports to partner countries under trade agreements constituted about two-fifths of Israel's total exports (and, it should be mentioned, the greater part of its exports apart from the two traditional export items of citrus fruit and polished diamonds); whereas imports from these countries reached only about one-sixth of its total imports. While the latter fraction is not insignificant, it seems that even at the peak, geographic discrimination in imports was not a major factor. From 1956 on, trade under payments agreements declined rapidly, although this was felt more in Israel's exports than in its imports. This decline was due to a combination of factors. One was a more effective use of the aforementioned price mechanism, which helped to direct exports—and to a smaller extent, imports—from the payments agreements countries to the open world market. Another factor was the move of the partner countries toward freer trade and currency convertibility; some important examples were the Netherlands, Norway, and Denmark. Turkey, the single most important partner country throughout the years, did not switch to complete convertibility; but this country, too, moved to rely considerably less on payments agreements after its substantial devaluation of 1958. Thus, beginning in the late 1950s, trade under payments agreements, and therewith administrative interference in the geographic allocation of imports, ceased to be a factor of much significance in Israel.

NOTES

1. In this section I draw substantially on Zvi Zussman, "The Foreign-Exchange Budget as a Forecast of Imports of Goods to Israel" (M.A. diss., Hebrew University, 1959; in Hebrew).

2. The budget year of the government of Israel runs from April to March.

3. Competent authorities for import licensing existed within the following ministries: Finance, Commerce and Industry, Health, Post (Communications), Agriculture, Labor, and Transportation. The division of authority among the ministries was determined according to the purpose of the imports. Thus, for instance, hospital equipment was handled by the Ministry of Health, tractors by the Ministry of Agriculture, etc. Sometimes, naturally, the dividing lines were not entirely clear-cut.

4. The principle of balancing the budget should not be taken too seriously. It should be recalled that the Department of the Budget had wide discretion in determining whether to include various categories of loans as receipts. Likewise, projected expenditures could include additions to foreign-exchange reserves. Such inclusions or exclusions could thus substantially alter the nature of a supposedly "balanced" budget.

5. The government did occasionally report the *number* of unsatisfied applications; for instance, out of a total of 5,435 applications made from May 1949 to February 1950, 1,726 were approved and the rest were either rejected or "remained under con-

sideration." There is no estimate, however, of the size (indicated value of imports) of each category of applications.

6. Partly to increase the proportion of licenses actually used, and to discourage applications intended as "safety margins," the government decided in later years to make applications more costly. After April 1956, an application had to be accompanied by a commitment to utilize the license within a specified time after it was granted, or pay a fee amounting to 10 per cent of the value of the license. This procedure did not work out very well and in March 1958 it was replaced by a requirement to deposit 10 to 20 per cent of the value of a license when it was granted. This requirement was also meant, however, to make imports more expensive and to tighten credit.

7. In a rather involved scheme, and with aid of the Jewish Agency, the government raised a special consolidation loan in the United States which was to be repaid from future contributions of the Jewish communities in the United States. The money was intended for the repayment of hard-pressing short-term foreign loans, and for the establishment of some minimum level of reserves. Since this loan was undertaken not directly by the government, but by the Jewish communities, it appears in balance-of-payments data as a unilateral transfer to Israel.

8. The study was conducted by Michael Rom (Rosenberg), and was summarized in a memorandum entitled, "A Report of the Sub-Committee for the European Common Market and Free-Trade Area on the Possibility of Israel Joining the E.E.C." (in Hebrew). The report was circulated in a few typed copies at the end of 1957.

9. "Imports without payment" was the term commonly applied to this category of transactions. Due to its popularity, it is used here too, although in effect, most of the imports concerned were *not* "without payment." The official term for this category was, indeed, more accurate and appropriate: "imports without allocation of foreign exchange."

10. If and when another source was illegally involved, such as repatriated foreign-exchange holdings of local residents, it had to be disguised as originating from one of these three legal sources.

11. In his budgetary speech of May 1950, the Minister of Finance estimated the rate of extra profits in imports of supposed "gifts" at 60–70 per cent.

12. After April, it will be recalled, the rate was determined by the government. As a result, very few transactions were conducted during the second half of the year in the organized market, to which the data refer.

13. As noted above, these imports constituted at that time 70 per cent of total imports via the IWP market.

14. Yoram Weiss, "Price Control in Israel, 1939–1963" (M.A. diss., Hebrew University, 1964; in Hebrew). Part of this study has been published in English: "Price Control in Israel, 1949–58," Bank of Israel *Economic Review* 37 (March 1971): 68–88.

15. Likewise, by all available accounts—which are obviously casual impressions rather than precise estimates—the quantitative extent of the black market reached its peak in that year.

It should be noted that the ratio of seven, mentioned in the text, is an average around which there was substantial variation. The most extreme item was sugar, for which the black-market price in 1951 was reported to be 25 times the official price.

16. On the strength of this association, it may be inferred that in 1959, a year in which the list of controlled items was reduced to half its size in 1958, the excess of free over controlled food prices must have become very small, perhaps insignificant. This inference would be supported by all available casual impressions: by the late 1950s black markets were rarely mentioned.

17. The ratio between the indices of free-market and official food prices was still over 5 in August 1952, the date to which this part applies.

18. In principle, a black-market rate higher than the formal one could thus exist even with a completely free movement of goods when controls are imposed on capital movements alone. This, indeed, has roughly been the situation in Israel since the late 1950s; during all these years, the black-market rate has been only moderately above the official rate, rarely exceeding the latter by more than 30 per cent.

19. Since the mid-1950s, transactions in the foreign-exchange black market are thought to be only in the neighborhood of $5 million–$10 million annually. The major component of net demand in the market is generally believed to be demand by emigrants, who have not been allowed foreign-exchange allocation for transferring their capital. Another important source—up to the late 1950s—was demand by Israeli tourists, because foreign-exchange allowances for travel were then nil.

20. This applies to the market in Tel Aviv. The rate in the Zurich market, confined mainly to currency notes, was sometimes substantially different, although major movements were similar in the two markets.

21. The substantial rise of the black-market rate in the last quarter of 1956 most probably reflects speculative demand due to the Sinai campaign in October of that year. The rate went down again a short time later. During the rest of the 1950s and 1960s, excluding short-term episodes when the black-market rate obviously rose owing to expectations of imminent devaluation, the excess of the black-market rate over the formal rate normally fell within a range of 10 to 25 per cent.

22. That is, the price-level-deflated effective exchange rate. The index used for the deflation abstracts from illegal markets.

23. For this calculation, defense materials are excluded from imports, since their somewhat erratic behavior has had little to do with economic forces, and may be misleading in the case of conclusions based on year-to-year comparisons.

24. This refers, of course, to prices of the finished product. Since imports of raw materials were mostly free of duty, this gap of 50 per cent could have meant, in some instances, very high protection rates. For industry as a whole the value added in the economy during the mid-1950s was below 50 per cent. With the average level of duties on raw materials being not more than a few percentage points, the 50 per cent gap would have meant an average effective protection rate of at least 100 per cent.

25. On average, this would have determined an effective protection rate quite similar to the 100 per cent effective protection rate implied (on average) in the former rule, in which a 50 per cent difference was allowed in the price of the final good.

26. For some evidence on this point, see Tsvi Goldberger (Ophir), "Protection Policy in Israel" (M.A. diss., Hebrew University, 1957; in Hebrew); and Alex Rubner, *The Economy of Israel* (London: Cass, 1960).

27. As was mentioned earlier, even imports which were presumably liberalized required import licenses, by which the importer could be required to purchase the good in a country other than the one of his choice.