

## BANK CREDIT AND INTEREST RATES

Since the volume of credit and its distribution are factors of decisive importance in all contemporary economies, central banks regard the regulation of these factors as their main task. Inflationary dangers, always prevalent when the economy of a country is rapidly developing, increase still further the importance of effective credit control.

Measures designed to direct the flow of credit have been enforced in Israel since 1950. Though no law existed delimiting its exact powers in this field, the Government of Israel, after consultations with the Advisory Committees for Banking and Credit Co-operative Societies, has from time to time issued instructions to banking institutions concerning the distribution of credit. The most important means of quantitative credit regulation were embodied in instructions regarding minimum liquidity ratios and the stabilisation of the volume of credit. The tools required for qualitative direction were provided by orders fixing priorities for the granting of credits to different branches of the economy, the fixing of the minimum percentage of total credit to be allocated to agriculture and the freeing of loans for certain essential purposes from liquidity requirements.

The Bank of Israel Law, 5714—1954, grants the Bank wide powers for regulating the quantity of credit and directing its flow. These include the power of issuing orders concerning minimum liquidity ratios, the stabilisation of the volume of credit, re-discounting, activities in the securities market, the determination of the interest rate and the granting of loans to the Government. (The legal powers of the Bank of Israel are described in detail in Chapter XVIII). Yet the prevalent conditions in the Israel economy place serious limitations on the efficacy of some of these powers. For instance, activities on the securities market in Israel are of little value in affecting the volume of credit or the money supply. The same is, of course, the case in other states without a developed security market. The most important instruments used by the Bank of Israel in 1955 for the regulation of credit were therefore instructions concerning liquidity, orders stabilising the volume of credit and re-discounting.

### 1. REGULATION OF THE VOLUME OF CREDIT

#### (a) *Liquidity Ratios*

The liquidity of banking institutions is measured by their ability to convert clients' deposits, and especially current deposits, into cash. The fact that banks do not maintain a liquidity ratio of 100 per cent enables them to create new money. During periods affected by inflationary tendencies, liquid assets of banking institutions increase and the institutions are, therefore, able to expand credit by an amount

several times greater than the total rise in the value of their liquid assets. This may well serve to increase inflationary pressure. On the other hand, when the prevailing tendency is deflationary, the volume of their liquid assets may contract; in such circumstances banking institutions generally restrict credit, which encourages a decline of economic activity. The planning of an increase or decrease in the liquidity of banking institutions is thus essential, if it is desired to stabilise production and employment on a high level.

The experience of many central banks has proved that fixing the minimum liquidity ratio is among the most effective means of regulating the volume of bank credit and, through it, the money supply. In countries where a well developed security market does not exist, liquidity regulations are the most important, indeed virtually sometimes the only means, of enabling the monetary authorities to influence the volume of credit.

In Israel, too, liquidity regulations provide the foundation on which rests the whole system of controlling the volume of credit. Instructions determining the minimum liquidity ratio for banking institutions in relation to their deposits were first issued in 1950. These instructions were changed from time to time, in particular through the fixing of higher marginal liquidity ratios for deposits created after a certain date. Although the minimum liquidity ratios were fixed at a very high level (the lowest ratio was 45 per cent and the highest 90 per cent, depending on the balances of deposits on certain dates), the banking institutions did, in fact, maintain lower ratios, since the authorities issued exemptions from the liquidity requirements for loans serving certain essential purposes. These exemptions affected both the volume and the qualitative distribution of credit.

In accordance with the powers conferred upon him by the Bank of Israel Law, the Governor of the Bank, after consultation with the Advisory Committee and with the approval of the Government, issued new instructions to banking institutions in December 1954. These made it obligatory for banking institutions to maintain certain liquidity ratios to demand deposits and time deposits for terms of 18 months or less. The liquidity ratios prescribed by these instructions, which remained in force throughout 1955, were as follows:

<i>Type of Deposit</i>	<i>Liquidity Ratio in per cent</i>
(i) Balances of banks in Israel	100
(ii) Balances of credit co-operative societies	60
(iii) Balances of banks abroad (including the head office, branches and correspondents)	100
(iv) Current deposits and deposits for periods not exceeding 18 months:	
(a) to the volume of these deposits on 31.3.1951	50
(b) to the volume of such deposits as accrued between 31.3.1951 and 31.12.1952 (or 31.3.1953, as	

desired by the banking institution)	75
(c) to the volume of such deposits as accrued after 31.12.1952 (or 31.3.1953), as desired by the banking institution.	90

These liquidity ratios are, in fact, similar to the ratios which banking institutions were ordered to enforce before the creation of the Bank of Israel, but the definition of liquid assets was expanded and now includes balances deposited with the Bank of Israel. For the purpose of present liquidity requirements, liquid assets are considered to be:

- (i) Balances deposited with the Bank of Israel
- (ii) Gold or silver coin and bullion held by the banking institutions
- (iii) Balances deposited in:
  - (a) an Israel banking institution other than a credit co-operative society
  - (b) banks abroad (including the head office, branches and correspondents)
- (iv) Treasury Bills
- (v) Certificates of the Financial Institutions 3 per cent Loans.

In order to ensure a firm basis for liquidity, the Bank of Israel issued an instruction in December 1954, ordering banking institutions to deposit with it balances to the value of 20 per cent of the liquid assets which they have by law to maintain on their deposits in Israel currency. (This instruction was issued after consultation with the Advisory Committee and with the approval of the Government). On the average, this was equal to 12.5 per cent of the deposits in Israel currency for which liquid assets had to be retained. Following the rapid increase in the money supply during the first months of 1955, these instructions were altered and banking institutions were required to place with the Bank of Israel 15 per cent of the deposits in Israel currency for which they are legally obliged to maintain liquid assets.

The Bank of Israel paid the following rates of interest on the balances of banking institutions deposited with it:

*Between 4 December 1954 and 15 May 1955:*

- (a) On 25 per cent of the minimum obligatory balance — No interest
- (b) On 75 per cent of the minimum obligatory balance — 1.5 per cent per annum
- (c) On the remainder of the balance — 2 per cent per annum

*After 15 May 1955:*

- (a) On 25 per cent of the minimum obligatory balance — No interest
- (b) On 75 per cent of the minimum obligatory balance — 2 per cent per annum
- (c) On the remainder of the balance — 2.5 per cent per annum

As from August 1955, the Bank of Israel paid interest at the rate of 3 per cent per annum on balances of banking institutions deposited with it for fixed periods exceeding three months.

Although this is contrary to the usage of most central banks, the Bank of Israel paid interest on a part of the balances deposited with it by banking institutions, in

order to make it easier for them to comply with the law requiring such deposits and to encourage them to increase these deposits above the compulsory minimum. In taking this step, the Bank of Israel took into consideration that banking institutions in Israel are accustomed to pay interest on the deposits of other banking institutions held with them.

Fluctuations in the liquidity of banking institutions during 1955 are shown in Table 125. The liquidity ratio of the banking institutions, according to this computation, rose from 38 per cent at the end of 1954, to 47 per cent in June 1955 and to 48.5 per cent at the end of 1955.

Table 125 describes the liquidity position in accordance with the definitions governing liquidity requirements, apart from the fact that the liquidity ratio was calculated in relation to total deposits, while the instructions fix liquidity ratios obligatory upon banking institutions with regard only to current deposits and to deposits for terms not exceeding 18 months. Since present banking usage sometimes permits depositors to draw on time deposits before their term has expired, it is advisable to examine liquidity in relation to *all* deposits, including those made for periods exceeding 18 months.

Present liquidity regulations do not distinguish between assets or deposits in Israel currency and in foreign currency. However, a sizable part of the banks' foreign currency deposits cannot be converted into Israel currency, as it represents liabilities in foreign currency, or funds made available by the Ministry of Finance or the banks' correspondents for revolving capital to finance documentary credits and other transactions. Hence, only the liquidity ratio to deposits in Israel currency is of importance as an instrument for influencing the money supply.

**TABLE 125**  
THE FORMAL LIQUIDITY OF BANKING INSTITUTIONS, 1955  
(in IL. millions)

	End of December 1954	End of March 1955	End of June 1955	End of September 1955	End of December 1955
Cash *	13.4	12.5	12.3	13.4	11.3
Balances with the Bank of Israel	32.1	50.6	69.2	72.2	83.7
Foreign Currency Balances, net	42.2	47.2	46.6	42.8	42.7
Treasury Bills	6.0	0.3	—	—	—
Government 3 per cent Loan	16.5	16.4	16.4	16.4	19.4
Balances in Transit between Banks	18.9	23.1	24.0	31.3	26.3
<i>Total of Liquid Assets</i>	129.1	150.1	168.5	176.1	183.4
Deposits in Israel Currency	281.2	303.9	317.3	331.0	349.3
Deposits in Foreign Currency	59.8	47.5	41.3	36.8	28.7
<i>Total Deposits</i>	341.0	351.4	358.6	367.8	378.0
Liquidity Ratio (in per cent)	37.9	42.7	47.0	47.9	48.5

\* Including gold and silver bars.  
SOURCE: Bank of Israel.

The definition of liquid assets for the purpose of liquidity requirements includes balances deposited in other banks. As a result of the present clearing arrangements, the total of balances registered as deposited with other banking institutions is actually greater than the total of balances registered as held on behalf of such institutions; the difference represents balances in transit. The fact that, for the purpose of liquidity requirements, balances registered as deposited with other banks constitute a liquid asset, served to inflate the amount of balances in transit and thus increased the formal liquidity ratios.

In order to establish the real liquidity situation in banking institutions, it is necessary to distinguish between assets of primary and secondary liquidity. Assets of the most liquid kinds, such as cash, balances with the Bank of Israel and Treasury Bills, belong to the first type. The second type includes assets whose conversion into cash is limited by certain restrictions, such as the Financial Institutions Loans, defined in the liquidity regulations as a liquid asset. In point of fact, the liquidity of this asset is very restricted, since banking institutions are required by law to invest in it 9 per cent of their deposits in Israel currency. The Government is obliged to redeem these loans only if the total of deposits in banking institutions drops, thus reducing the obligatory level of investment in the loans. Certificates of the Financial Institutions Loans are therefore a liquid asset only when the volume of bank deposits has fallen. At best, they can be described as of secondary liquidity.

Other countries usually include among assets of secondary liquidity, Government securities, insofar as a good market for them exists, and sometimes even "good" commercial bills of exchange held by the banks. But, in Israel, the money market is not sufficiently well developed to permit the large scale sale of Government securities—not to mention commercial bills of exchange—without heavy loss. Hence, these assets cannot be considered liquid. A computation of the liquidity of banking institutions in Israel currency, which distinguishes between primary liquid assets, secondary liquid assets and assets whose liquidity is purely formal, is presented in Table 126. This table shows that the liquidity of the banking institutions in local currency rose considerably during 1955. The ratio of primary liquidity increased from 18 per cent at the end of 1954 to 27 per cent at the end of 1955. The real liquidity ratio, which includes both primary and secondary liquid assets, rose from 24 to 35 per cent during 1955. The formal liquidity of the banking institutions increased from 31 to 40 per cent. The largest relative rise occurred, therefore, in the primary liquidity ratio which increased by some 50 per cent, while real liquidity rose by one-third.

The rise in the real liquidity of banking institutions in 1955 was due in the main to the following two factors:

(i) The volume of money deposited with banking institutions rose considerably (the various contributory factors are detailed in Chapter XIII), while the volume of credit granted by banking institutions from their own resources rose only slightly, as will be shown later in this chapter.

TABLE 126

THE LIQUIDITY OF BANKING INSTITUTIONS, IN ISRAEL CURRENCY, 1955  
(in IL. millions)

		End of December 1954	End of March 1955	End of June 1955	End of September 1955	End of December 1955
(1)	Cash *	13.4	12.5	12.3	13.4	11.3
(2)	Balances with the Bank of Israel	32.1	50.6	69.2	72.2	83.7
(3)	Treasury Bills	6.0	0.3	—	—	—
(4)=(1)+(2)+(3)	<i>Total Primary Liquid Assets</i>	51.5	63.4	81.5	85.6	95.0
(5)	Government 3 per cent Loan	16.5	16.4	16.4	16.4	19.4
(6)=(4)+(5)	<i>Total Real Liquid Assets</i>	68.0	79.8	97.9	102.0	114.4
(7)	Balances in transit between Banks	18.9	23.1	24.0	31.3	26.3
(8)=(6)+(7)	<i>Total Formal Liquid Assets</i>	86.9	102.9	121.9	133.3	140.7
(9)	Deposits in Israel Currency	281.2	303.9	317.3	331.0	349.3
				<i>in per cent</i>		
(10)=(4)/(9)	Primary Liquidity	18.3	20.9	25.7	25.9	27.2
(11)=(6)/(9)	Real Liquidity Ratio	24.2	26.3	30.9	30.8	32.8
(12)=(8)/(9)	Formal Liquidity Ratio	30.9	33.9	38.4	40.3	40.3

\* Including gold and silver bars.

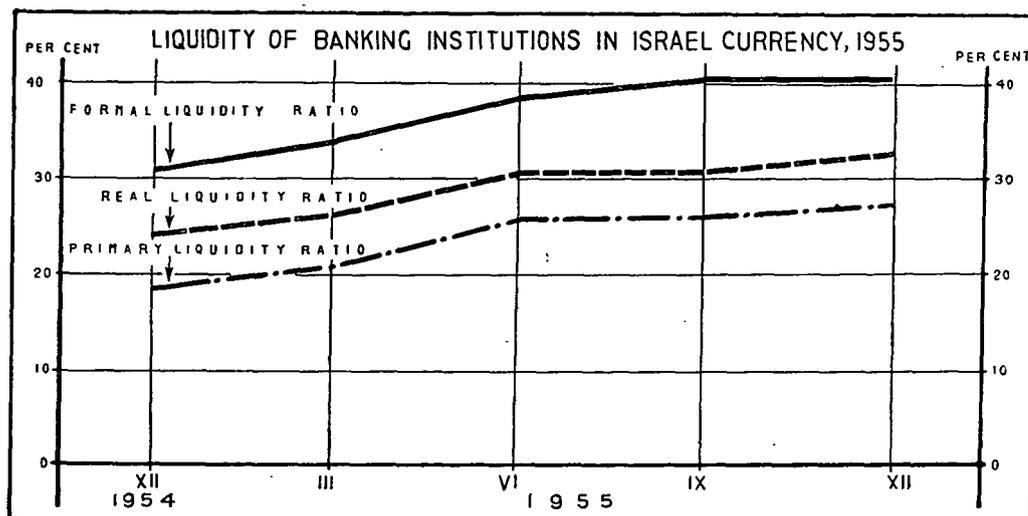
SOURCE: Bank of Israel.

(ii) The establishment of the Bank of Israel brought about important changes in the composition of liquid assets — the banking institutions transferred to the Bank of Israel during the first months of its operations most of their loans to the Government and a sizable proportion of their foreign currency balances, their balances with the Bank of Israel being credited with the counterpart. As already stated, balances in foreign currency were defined as liquid assets for the purpose of the liquidity requirements, but their real liquidity is smaller than that of balances with the Bank of Israel, especially when these exceed the obligatory minimum.

The composition of real liquid assets changed considerably in 1955. The banking institutions ceased to hold Treasury Bills, preferring to increase their balances with the Bank of Israel well above the compulsory minimum, as shown in Table 127. A certain amount of excess balances is required to cover possible fluctuations in inter-bank clearing. A further important reason for the existence of excess balances is the interest paid on them by the Bank of Israel.

(b) *Stabilisation of the Volume of Credit*

Instructions stabilising the volume of credit granted by banking institutions



**TABLE 127**  
BALANCES OF THE BANKING INSTITUTIONS WITH THE BANK OF ISRAEL, 1955  
(in IL. millions)

	End of March 1955	End of June 1955	End of September 1955	End of December 1955
Compulsory Minimum Balances	30.7	40.0	43.4	43.1
Excess Balances	19.9	29.2	28.8	40.6
<i>Total Balances</i>	50.6	69.2	72.2	83.7
Excess Balances as Percentage of Com- pulsory Balances	64.8	73.0	66.4	94.2

SOURCE: *Bank of Israel*.

proved an important instrument for the regulation of credit. At the beginning of 1954, the Government, after consultation with the Advisory Committees on Banking and on Credit Co-operative Societies, issued instructions to all banking institutions obliging them to stabilise the volume of credit granted by them (including discounts of bills and loans to the public both in Israel and foreign currency, but excluding loans made from Government deposits), at the level obtaining on 30 November 1953. During the period from August to October 1954, banking institutions were permitted by the Government to expand credit above this level by 4 per cent, provided that their liquidity situation permitted them to do so.

Although regulations stabilising credit are a somewhat clumsy and inelastic method of determining the volume of credit, the conditions prevailing in Israel necessitated their use. In order to prevent the expansion of credit to the public at a time when the liquid assets of banking institutions were rapidly increasing as a result of the conversion of foreign currency and the extension of credits to the Government, it became imperative to fix a 100 per cent liquidity ratio to additional deposits;

this is very much akin to the stabilisation of the volume of credit. However, while a 100 per cent liquidity ratio is likely to stabilise the volume of credit granted by the banking system as a whole, instructions stabilising credit are designed to prevent the expansion of credit by individual banking institutions, even when the liquidity of some institutions has increased and that of others has declined.

The liquidity requirements were defined so as to leave open many possibilities of credit expansion. Experience gained from the attempts to direct credit in 1952 and 1953 proved that, in spite of the high marginal liquidity ratios which amounted to as much as 90 per cent of deposits made after 31 December 1953 or 31 March 1954, the volume of credit continued to expand at a fairly rapid pace. This was due to the complicated nature of the repeatedly amended liquidity regulations, which provided many loopholes for those institutions wishing to circumvent their purpose. For example, the fact that foreign currency balances were defined as liquid assets for the purpose of liquidity requirements, permitted banks to expand credit in local currency after increasing their foreign currency holdings with their correspondents abroad. Furthermore, the regulations fixed liquidity ratios only with regard to current deposits and deposits fixed for terms not exceeding 18 months. This caused a relatively large increase in time deposits for terms exceeding 18 months, for which no liquid assets of any kind had to be maintained. The inclusion of all balances with other banks, even balances in transit, in the definition of liquid assets brought about the inflating of these balances and, as a result, some banking institutions possessed liquidity ratios which, while formally in order, were quite unreal. These and other technical deficiencies limited the effectiveness of liquidity regulations as the sole instrument of credit control. In the circumstances, regulations stabilising the volume of credit became an essential means of preventing further rapid credit expansion.

The regulations stabilising the volume of credit remained in force during 1955. The Bank of Israel Law empowers the Bank to forbid banking institutions to increase the volume of credit granted by them. However, for technical reasons, the Bank of Israel preferred not to base its instructions on this power, but on instructions issued by the Government in 1954, which also remained effective throughout 1955. As will be shown later in this chapter, these instructions did in fact prevent the expansion of credit to the public from the resources of banking institutions during 1955, despite the considerable rise in the total of liquid assets held by the banks.

### (c) *Re-Discounting*

Re-discounting is one of the most important instruments used by central banks to influence the volume and price of credit, and thereby, the levels of economic activity, incomes and prices. The raising of the re-discount rate is designed to reduce the amount of bills discounted by banking institutions in the central bank, diminish their liquidity and raise the rates of interest, especially on short term bank credits. In this way, the volume of credit and the money supply are contracted or their expansion is, at least, slowed down. Conversely, a reduction in the re-discount rate is intended to encourage the expansion of credit and of the money supply.

The effectiveness of re-discounting as an instrument for influencing the levels of income and economic activity is dependent on the following conditions:

- (i) The elasticity of the levels of economic activity, income and prices in relation to the interest rate and the volume of bank credit.
- (ii) The readiness of the banks to engage in re-discounting at the central bank, and their need to do so.
- (iii) The banks' possession of bills of exchange which the central bank is ready to discount.

Re-discounting is apt to be particularly effective when the banks are unaccustomed to maintaining surplus liquidity and try to keep their liquidity ratio more or less stable. Under such circumstances, the banks have only limited possibilities of credit expansion without resorting to re-discounting at the central bank and are forced to raise their interest rates and restrict credit, should the central bank raise the re-discount rate or restrict re-discounting.

Until the establishment of the Bank of Israel, no re-discounting facilities existed. The Issue Department of the Bank Leumi Le-Israel B.M. was indeed empowered by the Bank Note Ordinance of 5708-1948 to discount debtors' bills and bills of exchange and to include them among the assets used to provide cover for currency in circulation; however, in point of fact, it never did so.

The Bank of Israel, in accordance with the powers conferred upon it by law, began to re-discount bills in Israel currency in February 1955. The balance of outstanding re-discounts grew steadily, reaching IL.9.5 millions at the end of 1955. The re-discount rate was fixed at 6 per cent per annum, and the banking institutions were permitted to obtain from their clients interest at the rate of 8.5 per cent per annum, including commission and all other extra payments, on credits which they had re-discounted. Documents, which the Bank of Israel is prepared to re-discount to a limited extent, include bills of agricultural and industrial concerns, whose output increases exports, provides a substitute for essential imports or makes some other essential contribution to the national economy. In addition, the Bank of Israel began, in August 1955, to carry out re-discounting in foreign currency for the financing of imports for exports. The sum total of such re-discounts outstanding at the end of 1955 was IL.6.1 millions. (Details of the procedure for re-discounting are given in Chapter XVIII).

On the whole, the banking institutions took full advantage of the re-discount facilities offered by the Bank of Israel. In fact, re-discounting provided virtually the only means by which banking institutions could expand their credit, since the liquidity regulations and the regulations stabilising the volume of credit prevented them from expanding credit from their own resources. Nor were the banking institutions short of bills which met the required conditions for re-discounting laid down by the Bank of Israel. The latter, however, decided to restrict the amount of re-discounting and refused to discount such bills in unlimited quantities. This was done to prevent a large

expansion in the volume of credit during a period when the money supply was rapidly increasing for other reasons, as described in Chapter XIII. As a result, re-discounts in Israel currency, at the end of 1955, totalled only 4 per cent of the volume of bank credit granted to the public. Re-discounting did not, therefore, in that year fulfil its classic function of influencing the rate of interest on all loans made to the public at the relatively low rate of 8.5 per cent. On the other hand, re-discounting did, to a very considerable extent, determine the speed at which credit to the public was expanded. Practically the entire credit expansion was directed to purposes enjoying a high priority from the viewpoint of the national economy. Re-discounting, employed in accordance with the conditions prevailing during this period, thus became an important instrument enabling the Bank of Israel to influence the volume of credit and its qualitative direction.

## 2. DEVELOPMENTS IN THE VOLUME OF CREDIT GRANTED TO THE PUBLIC

### (a) *Credit Granted to the Public from the Resources of the Banking System*

Local currency credits granted to the public from the resources of the banking system during 1955, expanded from IL.217.4 millions to IL.237.4 millions, an increase of some IL.20 millions or 9 per cent. Sources of credit to the public and fluctuations in its volume are shown in Table 128.

Several factors caused the expansion in the volume of local currency credit. Some IL.10 millions were due to the re-discounting activities of the Bank of Israel. Additional credit to the amount of IL.6.7 millions was granted by banking institutions from monies in the Employment Fund and various joint funds of the Government and the Jewish Agency; credits from these funds are not subject to the instructions stabilising the volume of credit. Local currency credit from the resources of banking institutions was expanded by a further IL.3.6 millions owing to corresponding reductions in the volume of their foreign currency credits to the public: these credits were included in the definition of credit for the purpose of the regulations stabilising its volume.

The major expansion of credit in Israel currency took place in the first quarter of 1955, when outstanding credit granted by banking institutions from their own resources increased by IL.14 millions, while outstanding re-discounts by the Bank of Israel totalled only IL.1 million. On the other hand, the balance of re-discounts rose by IL.8.5 millions during the last nine months of the year, while the balances of credit granted to the public during this period from the resources of the banking institutions diminished by more than IL.3 millions. The volume of bank credit to the public, including credits granted as a result of re-discounting by the Bank of Israel, increased in 1955 to a considerably lesser extent than in previous years. (See Table 128\*).

\* Since no distinction was made until the end of 1953 between Israel currency credits and foreign currency credits, Table 128 combines the total rise in the volume of foreign and local currency credit granted to the public. It can, however, be assumed that the trend would not show serious changes if the comparison had been made between figures relating to credit in Israel currency alone.

granted from the resources of banking institutions and credit from Government deposits. While the granting of additional credit by the banking system creates new purchasing power, credits from Government deposits are given, to the extent that the budget is balanced, from monies previously siphoned off from the public. The granting of such loans does not, therefore, create new money. An exception to this rule is provided when credits are granted to the public in Israel currency from Government deposits created by cash receipts from foreign loans.

Loans from Government deposits are granted from Development Budget funds for periods averaging nine years, at rates of interest ranging from 6 to 7 per cent per annum. Such loans are usually granted for the purchase of imported equipment or for local investment expenditure. However, loans from the Development Budget

TABLE 129

CREDIT GRANTED TO THE PUBLIC BY BANKING INSTITUTIONS FROM GOVERNMENT DEPOSITS, 1955  
(in IL. millions)

	End of 1954	End of 1955	Increase
To Importers within the framework of Reparations and the U.S. Grant-in-Aid	12.4	14.8	2.4
To Income Tax Debtors	8.0	21.2	13.2
To Distributors of Popular Loan Certificates	2.4	2.6	0.2
<i>Total</i>	22.8	38.6	15.8
From the Development Budget and Special Deposits	69.3	104.2	34.9
<i>Grand Total</i>	92.1	142.8	50.7

SOURCE: *Bank of Israel.*

are sometimes given for turnover capital, if the undertaking concerned is one which the Government wishes to encourage. The object of this type of loan is generally to encourage exports or to increase essential production in agriculture or industry.

Short term advances, usually for periods of a few months, were also granted through banking institutions for the import of raw materials under the Reparations Agreement or from funds provided by the U.S. Grant-in-Aid. The banking institutions credited the Government with time deposits as an offsetting item.

Furthermore, the banking institutions granted credit to income tax debtors for the partial payment of income tax liabilities accrued from previous years. Similarly, against such loans, the banking institutions credited the Government with time deposits due for payment after the date of redemption of the loans. Small credits from Government deposits were also granted to distributors of Popular Loan Certificates.

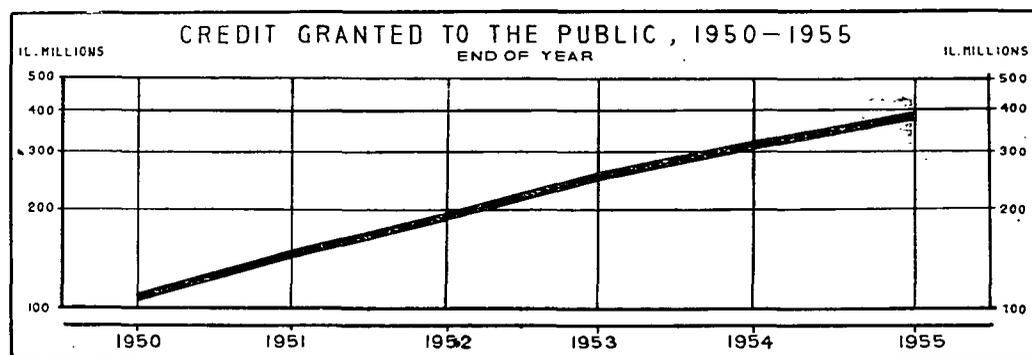
Loans for imports under the Reparations Agreement or from funds provided by the U.S. Grant-in-Aid, as well as loans to income tax debtors and distributors of

**TABLE 128**  
**BANK CREDIT GRANTED TO THE PUBLIC IN ISRAEL CURRENCY AND IN FOREIGN CURRENCY,**  
**1950 TO 1955**  
*(in IL. millions)*

	End of 1950	End of 1951	End of 1952	End of 1953	End of 1954	End of 1955
From the Resources of Banks	85.3	100.1	121.5	152.9	176.9	184.0 *
From the Resources of Credit Co-operative Societies	19.8	26.7	33.1	43.6	50.2	50.0 *
From the Resources of the Bank of Israel	—	—	—	—	—	15.6
<i>Total Bank Credit</i>	105.1	126.8	154.6	196.5	227.1	249.6 *
From Government Deposits	—	22.4	35.5	56.6	92.1	142.8
<i>Total Credit Available to the Public</i>	105.1	149.2	190.1	253.1	319.2	392.4 *
Percentage Rise in the Volume of Bank Credit	—	20.6	21.9	27.1	15.6	9.9
Percentage Rise in the Total Volume of Credit	—	42.0	27.4	33.1	26.1	22.9

\* Including Employment Fund; excluding interest for future years.

SOURCE: Central Bureau of Statistics and the Bank of Israel.



The slowing-down of the rate of credit expansion shows that the quantitative controls imposed functioned quite efficiently during 1955. This fact is especially worthy of mention, since the total real liquid assets of the banking institutions increased considerably in the course of 1955, as previously shown. Had the banking institutions continued to maintain the same ratio of primary liquidity during 1955 as was current at the end of 1954, they would have been able to increase their credits to the public by nearly IL.35 millions\*.

*(b) Credit Granted to the Public from Government Deposits*

In addition to credit granted from the resources of the banking system, the public received numerous loans from Government deposits through the intermediary of banking institutions. There is an important difference in principle between credit

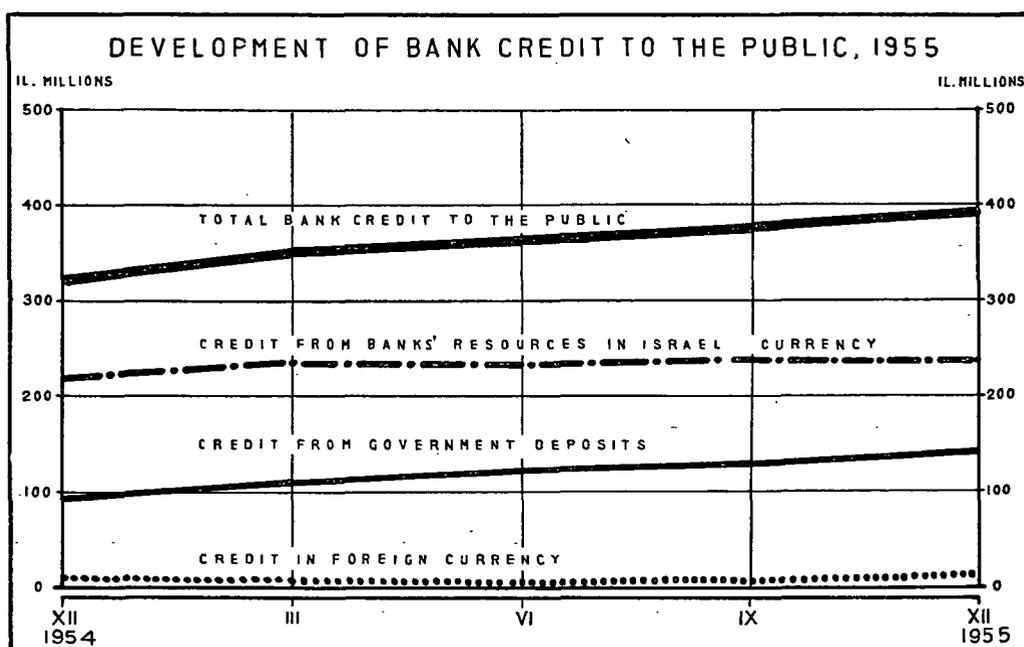
\* This calculation has been made on the basis of the estimated distribution of the additional money supply between deposits and cash, according to the proportions obtaining at the end of 1955.

Popular Loan Certificates, constitute deferments of payments due to the Government from the public. This increases the liquidity of the debtors concerned. Banking institutions are not obliged to maintain liquid assets against Government deposits connected with loans of the types referred to in this paragraph, to the extent that the loans were in fact granted.

In 1955, credits granted to the public from various Government deposits increased by 55 per cent, as shown in Table 129.

(c) *Foreign Currency Credits Granted to the Public*

The total volume of credit granted by banking institutions in foreign currency during 1955, mainly for financing imports, decreased by IL.3.6 millions. On the other hand, additional foreign currency credit was made available to the public through re-discounts in the Bank of Israel, at 5 per cent interest, for purchase of



materials required for export production. Re-discounts of this kind totalled IL.6.1 millions at the end of 1955. The total of foreign currency credits thus increased by IL.2.5 millions during 1955 (see line (10) of Table 130).

(d) *Total Volume of Credit Granted to the Public*

The total value of outstanding bank credit to the public, including credits from various Government deposits and foreign currency credits, rose from IL.319.2 millions at the end of 1954 to IL.392.4 millions at the end of 1955, representing a rise of IL.73 millions or approximately 23 per cent. (see line (15) of Table 130). Approximately IL.50 millions of this increase is accounted for by the greater volume of credit granted from Government deposits, generally, long term credits or credits against which

**TABLE 130**  
**BANK CREDIT GRANTED TO THE PUBLIC, 1955**  
*(in IL. millions)*

	December 1954	March 1955	June 1955	September 1955	December 1955	
<i>Credit from the Resources of the Banking System In Israel Currency</i>						
(1)	From Resources of Banks *	167.2	177.3	178.7	183.3	180.2
(2)	From Resources of Credit Co-operative Societies *	50.2	56.1	54.9	55.1	53.8
(3)=(1)+(2)	From the Resources of Banking Institutions	217.4	233.4	233.6	238.4	234.0
(4)	Less: Credit created by Registration of Interest for Future Years	—	2.1	5.4	6.2	6.1
(5)=(3)-(4)	Actual Credit from the Resources of Banking Institutions	217.4	231.3	228.2	232.2	227.9
(6)	Re-discounting by Bank of Israel	—	1.0	4.1	7.3	9.5
(7)=(5)+(6)	Total Bank Credit in Israel Currency	217.4	232.3	232.3	239.5	237.4
<i>In Foreign Currency</i>						
(8)	From Resources of Banks *	9.7	7.7	6.0	5.2	6.1
(9)	Re-discounting by Bank of Israel	—	—	—	2.4	6.1
(10)=(8)+(9)	Total Bank Credit in Foreign Currency	9.7	7.7	6.0	7.6	12.2
(11)=(7)+(10)	Total Credit to Public from Banking System	227.1	240.0	238.3	247.1	249.6
<i>Credit from Government Deposits</i>						
(12)	From Government Deposits Earmarked for Loans	69.3	78.0	83.2	91.8	104.2
(13)	From other Government Deposits	22.8	31.9	40.5	37.5	38.6
(14)=(12)+(13)	Total Credit from Government Deposits	92.1	109.9	123.7	129.3	142.8
(15)=(11)+(14)	Total Credit Granted to the Public	319.2	349.9	362.0	376.4	392.4

\* Including credits granted from third party deposits and from the Employment Fund.  
SOURCE: Bank of Israel.

deposits were made available to the Government by the banks. Some of the credit granted by banking institutions from the Employment Fund and other public funds likewise originated from Government monies. Thus, in 1955, some three-quarters of the additional credit to the public were granted against Government deposits, i. e. without infusing additional purchasing power into the economy. Further credit, to the amount of IL.16 millions, was granted for essential purposes through local and foreign currency re-discounts with the Bank of Israel. The banking institutions converted foreign currency credits into credits in Israel pounds to the extent of IL.3.6 millions, but they did not increase the amount of credit to the public from their own resources.

### 3. CREDIT GRANTED TO THE GOVERNMENT

The Bank of Israel acts as the banker and fiscal agent of the Government. Most of the Government's credit and debit accounts were gradually transferred to the Bank during 1955, though a few are, for technical reasons, still retained with banking institutions. As a result, the Government's deposits and credit balances in banking institutions were considerably reduced.

On the other hand, the Government received advances from the Bank of Israel for the financing of its current activities. In accordance with Section 45 of the Bank of Israel Law, the Bank is empowered to grant temporary advances to the Government for the financing of current expenditure, as long as the total of such advances does not exceed 20 per cent of the Government's budget for the year concerned, excluding the Development Budget and the self-balancing budgets for transportation and communication enterprises. Advances to the Government by the Bank of Israel during the first two months of 1955 totalled IL.15 millions. As prescribed by the law, the Government repaid these advances in March 1955, prior to the termination of its financial year, mainly by the sale of Treasury Bills to the Bank of Israel. With the beginning of the new financial year, the Government once again received advances, which totalled some IL.20 millions by the end of April. The volume of these advances gradually increased during the following months, reaching IL.30.8 millions at the end of October. Advances to the Government by the Bank of Israel during the last six months of 1955 totalled approximately IL.28 millions. In addition to financing a part of the Government's current expenditure by advances, the Bank of Israel administered its special credit and debit accounts, as described in detail in Chapter XVIII.

The sale of Treasury Bills represented another source of credit for the Government. These Treasury Bills are issued for terms of 91 days and pay interest at the rate of 2 per cent per annum. The total amount of Treasury Bills issued is IL.69.4 millions, but the value of Treasury Bills held by the Bank of Israel fluctuated in 1955 between IL.41 millions and IL.65 millions. The remaining Treasury Bills were retained by the Ministry of Finance.

In order to establish the net credit situation of the Government, it is necessary to deduct from its credit balances the value of its deposits with the Bank of Israel and the banking institutions. The latter belong to the Ministry of Finance and certain

other government bodies. During the last months of 1955, the Government was further credited with the deposits of the Defence Fund.

As shown in Table 131, the total amount of net credit granted to the Government rose during the second quarter of 1955 (i.e. at the beginning of the Government's financial year) by IL.23 millions. During the third quarter, it fell by IL.9 millions, while in the last quarter it increased again by IL.5.5 millions. In the course of 1955, the volume of credit received by the Government from the banking system expanded by more than IL.20 millions. This was one of the three main reasons for the increase in the money supply (see also Chapter XIII).

In addition to credits in Israel currency, the Government received foreign currency credits from the banking system. However, it also deposited foreign currency with the banks. The volume of foreign currency credits received by the Government from banking institutions reached IL.8 millions at the end of June 1955. During the second half of 1955, the Bank of Israel put at the Government's disposal foreign currency credits which totalled IL.10 millions by the end of the year, mainly to finance the laying-in of stocks and special purchases abroad. Moreover, foreign currency credits received by the Government from banking institutions were expanded by IL.5 millions in the last six months of the year. The fluctuations in the volume of foreign currency credit granted to the Government by the Israel banking system are set out in Table 131. Since the Government usually purchases foreign currency from the Exchange Fund and pays for it in Israel pounds, foreign exchange credits from the Bank of Israel cause a reduction in the Government's local currency requirements.

During the first years of Statehood, the expansion of bank credit to the Government was a prime cause of increases in the money supply. This increased much faster than the rate at which credit to the Government was being expanded, since the latter form of credit was usually granted against the sale to banking institutions of Government securities possessing a high degree of liquidity. Since neither high marginal liquidity ratios nor instructions stabilising the volume of credit granted by banking institutions existed at the time, this procedure enabled the banks to expand credit to the public, thus increasing the money supply still further.

The expansion of credit to the Government by way of advances from the Bank of Israel does not directly increase the liquidity of banking institutions. However, such credit expansion leads to an increased money supply and may be reflected in larger bank deposits. Banking institutions thus receive additional liquid assets, on the basis of which they are able to grant more credit and to increase the money supply further. This effect on the money supply of credits granted to the Government was prevented by the instructions stabilising the volume of credit in 1955.

There is no fundamental difference between the expansion of credit to the Government and the granting of additional credit to the public, when the effect upon the volume of economic activity and the demand for goods and services in the economy is considered. Credit given to the Government is just as effective a means

**TABLE 131**  
**CREDIT GRANTED TO THE GOVERNMENT, 1954 AND 1955**  
*(in IL. millions)*

		Dec. 1954	March 1955	June 1955	Sept. 1955	Dec. 1955
	<i>In Israel Currency</i>					
(1)	Advances from Bank of Israel	11.1	—	22.3	28.2	26.1
(2)	Other Accounts (net)	—	—	0.8	—0.9	6.7
(3)	Treasury Bills	47.3	64.9	63.1	51.6	57.1
(4)	Gross Credit from Banks	7.2	2.1	2.9	3.2	5.6
(5)=(1)+(2)+(3)+(4)	<b>Total Gross Credit</b>	<b>65.6</b>	<b>67.0</b>	<b>89.1</b>	<b>82.1</b>	<b>95.5</b>
(6)	<i>Less: Deposits with the</i>					
	Bank of Israel *	—	2.1	3.0	4.8	16.3
(7)	Current Deposits in Banks	10.5	7.7	6.1	6.2	2.6
(8)=(5)—(6)—(7)	<b>Total Net Credit</b>	<b>55.1</b>	<b>57.2</b>	<b>80.0</b>	<b>71.1</b>	<b>76.6</b>
	<i>In Foreign Currency</i>					
(9)	Advances from Bank of Israel	—	—	—	10.2	5.6
(10)	Credit from Banks	0.5	9.0	7.4	5.0	14.1
(11)=(9)+(10)	<b>Total Gross Credit</b>	<b>0.5</b>	<b>9.0</b>	<b>7.4</b>	<b>15.2</b>	<b>19.7</b>
(12)	<i>Less: Deposits with the</i>					
	Bank of Israel	—	—	5.0	3.0	0.7
(13)	Current Deposits in Banks	0.9	0.9	0.6	0.4	0.4
(14)=(11)—(12)—(13)	<b>Total Net Credit</b>	<b>—0.4</b>	<b>8.1</b>	<b>1.8</b>	<b>11.8</b>	<b>18.6</b>

\* Including deposits of government institutions and the Defence Fund.

SOURCE: *Bank of Israel.*

of raising the purchasing power of the population, even though it does so by increasing activity in the governmental sector of the economy. It is therefore advisable to regard the expansion of credit to the Government and the public as a single problem and to examine it with a view to regulating the resultant increase in the money supply in accordance with requirements. The question of how to divide additional credit between the Government and the public thus resolves itself into the question: to what extent is it desirable to encourage the development of the governmental sector of the economy as against that of the non-governmental sectors?

#### 4. THE QUALITATIVE REGULATION OF CREDIT

Since the long term requirements of a national economy often do not coincide with short term business interests, the authorities must regulate the use of the available factors of production in accordance with a scale of priorities determined by the needs of the economy. In many cases, credit is one of the deciding factors in activating the means of production, and its qualitative regulation thus exercises a considerable influence on the distribution of resources within the economy. The prime object of qualitative regulation is to direct a larger volume of credit to purposes which should receive priority from the point of view of the national economy. In the case of Israel, the most important of these is production, which increases exports or restricts imports. On the other hand, qualitative regulation should ensure the reduction

in the volume of credit allocated for purposes of low priority, such as expanding consumption.

Qualitative regulation is, however, of limited value during periods when inflationary tendencies are active, unless accompanied by effective restrictions on the quantity of credit. Even when the additional credits are granted for the most essential and productive purposes, they increase the purchasing power of the workers, employers and suppliers involved in such production, as well as their expenditure on consumption. Additional credit for productive projects therefore increases the flow of purchasing power into the normal economic channels and, after the initial stage, there is no difference between such money and any other. This fact is especially important in Israel, where the marginal propensity to spend is generally high and every increase in the volume of credit is thus accompanied by a disproportionate rise in effective demand. Qualitative regulation alone is therefore insufficient to prevent inflationary dangers created by the expansion of credit. The fundamental test of the effectiveness of qualitative regulation in an inflationary period is the extent to which it is able to change the distribution of credit without increasing its existing volume.

Measures designed to ensure the qualitative regulation of credit were first implemented in Israel towards the end of 1950. At that time, the Advisory Committee for Banking issued a circular to banking institutions requesting them not to grant credit for consumption, nor to grant loans liable to encourage the speculative hoarding of goods. In April 1951, the banking institutions were requested not to give credits for the purchase of gold or securities and to reduce the credit for building. In April 1953, the Government, after consultations with the Advisory Committees for Banking and Credit Co-operative Societies, instructed all banking institutions to allocate a minimum of 20 per cent of their outstanding volume of credit to agriculture. During the period August—October 1954, the banking institutions were permitted, in accordance with a Government decision, to expand the volume of credit by 4 per cent, on condition that half this increase was channelled to agriculture and half to industry. In this way, banking institutions were obliged to earmark 22 per cent of their total credits for agriculture.

As from 1953, the Government has, at various times, granted exemptions from liquidity requirements for loans designed to serve certain essential purposes\*. The instruction fixing high liquidity ratios (exemptions from which were granted exclusively for essential projects) thus came to serve as a means of qualitative, no less than quantitative, credit regulation.

Owing to these measures, the proportion of credit allocated to agriculture and the essential branches of industry increased. The share of agriculture in total credits granted from the resources of the banks rose from 15.5 per cent at the end of 1951 to 22.6 per cent at the end of 1954, while the share of industry increased during the same period from 16.5 to 29.0 per cent (see Table 132).

\* This was effected by the deduction of such loans from the total of liquid assets which the banking institution was obliged to maintain according to the regulations.

Experience has shown that the most serious limitation of qualitative regulation is that it enables banking institutions to allocate credit from their own resources for purposes which bear low priority, but which provide a better business return, in anticipation that the special arrangements will provide credit for essential projects.

The Law confers powers upon the Bank of Israel for the qualitative regulation of credit. These include: the granting of credit to banking institutions against documents, the character of which is determined by the Bank of Israel; the stabilisation of a certain type of credit or investment; the fixing of the minimum ratio of capital to a certain type of asset; and the determination of differential minimum rates of cash payments against various kinds of transactions financed by letters of credit. (Sections 42, 53, 55 and 56 of the Bank of Israel Law; see also Chapter XVIII).

The Bank of Israel possesses extensive indirect powers for increasing the flow of credit to projects advantageous to the national economy, as well as direct powers to prevent the granting of credit for undesirable purposes. Moreover, the Bank of Israel can direct the distribution of bank credit by means of persuasion and moral pressure, which are among the most important weapons of all central banks.

Regulations affecting the qualitative direction of credit enacted prior to the establishment of the Bank of Israel have remained in force. The banking institutions are still obliged to allocate not less than 22 per cent of their total credit balances to agriculture. Such exemptions from liquidity requirements as have been granted, affected projects of high priority, and the banking institutions receiving these exemptions were often required to allocate additional credit for the same purpose within the framework of the liquidity regulations. Another important instrument of qualitative credit regulation — re-discounting — was likewise introduced. (Its function was described in section (1) (c) above). The Bank of Israel examined every bill presented by the banking institutions for re-discounting and only agreed to discount bills that financed the production of export commodities, import substitutes or other essential goods.

Qualitative regulation brought about a considerable rise in the proportion of credit allocated for essential purposes. During 1955, the share of credit granted to agriculture from the resources of the banking institutions rose from 22.6 to 26.2 per cent of the total; while the share of industry advanced from 29.1 to 29.8 per cent, as shown in Table 132. These improvements took place at a time when the total volume of credit granted to the public increased only to a limited extent.

Credits from Government deposits were allocated for projects of high priority, and this increased the share of those branches producing essential goods in the total volume of bank credit. The share of total bank credit granted to agriculture increased during 1955 from 31.5 to 36.3 per cent and that granted to industry from 23.4 to 24.3 per cent, as shown in Table 132. The same tendency was apparent in credits given during 1955 by credit co-operative societies, including credits from Government deposits. The share of agriculture and of industry rose, as shown in Table 133. The

credit situation in the several branches of the economy is described in those parts of this Report that deal with the development of agriculture, industry and building (Chapters VIII, IX, and XI).

## 5. THE SHORTAGE OF CREDIT

Even after the introduction of the New Economic Policy, credit to the public continued to expand at a very considerable rate. The increase was by 22 per cent in 1952, 27 per cent in 1953, 16 per cent in 1954 and 10 per cent in 1955 (see Table 128). Nevertheless, the general feeling that credit is short has, since 1952, been one of the outstanding phenomena of economic development in Israel. This shortage represents the gap between the total amount of credit requested by the public at the legal rate of interest and the amount of credit the banking system is ready to supply to the public in accordance with existing regulations. As a result of this situation, a part of the public took up credits from certain banking institutions and other lenders at a rate of interest higher than that permitted by law.

The following were the most important factors that caused a credit shortage in Israel over the last few years:

(i) A shortage of credit usually occurs during a period when attempts are being made to put an end to inflationary developments. During an inflation, most enterprises use all the financial resources at their disposal to purchase equipment or raw materials so that when the rise in the volume of credit and the money supply is arrested, a general shortage of money is created.

(ii) As a result of the continual rise in the price level in Israel, investment in new enterprises or existing undertakings in the process of expansion, required far greater sums than was anticipated at the outset. The largest rise was in the payments for equipment and raw materials, as a result of the depreciation of the Israel pound to a fifth of its former value in terms of foreign currency during the years 1953 to 1954. Hence, the liquidity situation of many undertakings worsened and some were not only unable to finance their current needs from their own resources, but were forced to use short term credits for the financing of investment.

(iii) The tendency in Israel to undertake investment without adequate financial resources often forces public institutions and other concerns into a financial crisis and a chronic reliance on large scale borrowing.

(iv) The lengthening of the production process in certain branches by the change-over to local raw materials, or by local production of commodities previously imported, required greater working capital than in previous years, when the raw materials or finished products were being imported from abroad.

(v) The shortage of credit was particularly felt in some of the enterprises established in 1954 and 1955, as well as in enterprises which greatly expanded the scope of their activities during these years. This was due to the enactment, early in 1954, of regulations stabilising the volume of credit.

TABLE 132

DISTRIBUTION OF CREDIT GRANTED BY BANKS, BY SECTORS, 1951 TO 1955

## A. Excluding Credit Granted by the Israel Bank of Agriculture and from Government Deposits

	End of 1951		End of 1952		End of 1953		End of 1954		End of 1955	
	IL. millions	per cent								
To Government	—	—	2.1	1.9	19.3	11.4	—	—	—	—
To Local Authorities	2.9	2.9	3.1	2.9	3.1	1.8	2.3	1.3	1.9	1.0
To Gas, Electricity and Water Companies	4.3	4.3	4.7	4.3	4.7	2.8	7.8	4.3	4.1	2.1
To Credit and Financial Institutions	7.1	7.1	5.6	5.1	7.4	4.4	5.2	2.8	6.7	3.4
To Institutions Organising Settlement	—	—	3.2	2.9	3.5	2.1	3.3	1.8	3.0	1.5
To Agriculture	15.5	15.5	20.3	18.4	29.4	17.4	41.4	22.6	51.5	26.2
To Industry	16.5	16.5	25.0	22.7	43.0	25.4	53.2	29.1	58.7	29.8
To Building	9.0	9.0	9.2	8.4	14.0	8.3	17.4	9.5	13.4	6.8
To Commerce	14.6	14.6	16.9	15.3	22.9	13.5	29.8	16.3	29.4	14.9
To Others	30.1	30.1	19.9	18.1	21.9	12.9	22.4	12.3	28.3	14.3
<i>Total</i>	100.0	100.0	110.0	100.0	169.2	100.0	182.8	100.0	197.0	100.0

B. Including Credit Granted by the Israel Bank of Agriculture and from Government Deposits

	End of 1951		End of 1952		End of 1953		End of 1954		End of 1955	
	IL. millions	per cent								
To Government	—	—	2.1	1.4	19.3	8.6	—	—	—	—
To Local Authorities	3.3	2.7	7.0	4.7	9.2	4.1	9.0	3.5	12.4	4.0
To Gas, Electricity and Water Companies	4.5	3.7	5.6	3.8	4.9	2.2	8.3	3.2	5.2	1.7
To Credit and Financial Institutions	8.4	7.1	7.4	5.0	8.9	4.0	6.9	2.7	9.1	2.9
To Institutions Organising Settlement	—	—	16.0	10.8	15.5	6.9	12.7	5.0	11.4	3.7
To Agriculture	21.1	17.4	33.4	22.6	54.2	24.2	80.6	31.5	112.6	36.3
To Industry	17.0	13.7	27.0	18.2	46.5	20.8	59.8	23.4	75.4	24.3
To Building	9.7	8.0	11.2	7.6	15.8	7.1	21.7	8.5	21.6	6.9
To Commerce	15.1	12.4	16.9	11.4	24.9	11.1	31.6	32.3	30.4	9.8
To Others	43.0	35.0	21.5	14.5	24.3	11.0	25.1	9.9	32.0	10.4
<i>Total</i>	122.1	100.0	148.1	100.0	223.5	100.0	255.7	100.0	310.1	100.0

SOURCE: *Bank of Israel.*

TABLE 133

DISTRIBUTION OF CREDIT GRANTED BY CREDIT CO-OPERATIVE SOCIETIES, BY SECTOR, 1951 TO 1955\*

	End of 1951		End of 1952		End of 1953		End of 1954		End of 1955	
	IL. millions	per cent								
To Government	—	—	—	—	—	—	0.6	0.9	—	—
To Local Authorities	1.0	4.1	1.3	3.8	3.6	7.5	4.1	6.0	3.9	5.1
To Gas, Electricity and Water Companies	—	—	0.9	2.5	1.3	2.7	0.4	0.7	0.3	0.4
To Credit and Financial Institutions	—	—	—	—	—	—	1.7	2.6	2.2	2.9
To Institutions Organising Settlement	—	—	—	—	—	—	0.2	0.2	—	—
To Agriculture	3.8	14.7	4.5	13.6	9.0	18.7	14.8	21.7	17.1	22.3
To Industry	2.0	7.7	2.6	7.9	4.6	9.5	4.6	6.6	5.9	7.7
To Building	8.5	33.2	10.2	30.7	13.5	28.1	15.4	22.7	7.5	9.7
To Commerce	1.8	6.9	2.6	7.8	4.1	8.5	7.2	10.6	8.2	10.6
To Others	8.5	33.4	11.2	33.7	12.0	25.0	19.0	28.0	31.6	41.3
<i>Total</i>	25.6	100.0	33.3	100.0	48.1	100.0	68.0	100.0	76.7	100.0

\* Including credit from Government deposits.

SOURCE: Bank of Israel.

The causes of the credit shortage affected many branches of the economy, but there were other special factors affecting individual sectors. These factors are dealt with in Chapters VIII, IX and XI concerning agriculture, industry and building.

The credit policy of the Bank of Israel during 1955 had two main objectives:

1. A careful and limited increase in the volume of credit for purposes of high priority to the national economy, such as encouraging further production for export or for import substitution.
2. The increase in the share of agriculture and industry within the existing credit framework.

The Bank of Israel increased the volume of credit for essential branches of the economy only to the extent that these branches increased their output. It did not meet demands for credit expansion caused by a rise in prices, since the process of price increases not only feeds on credit expansion and a growing supply of money, but is often caused by these very phenomena. The constant adjustment of credit and the money supply to a rising price level, for whatever cause, is liable to lead to a vicious circle of rising prices and an increasing money supply; this eventually brings about a runaway inflation. Even in cases where prices are being raised as a result of increased production costs, monetary policy must be designed to ensure that cost inflation is not aggravated by demand inflation. Restrictions on the expansion of credit, whatever awareness of credit shortage they may cause, are an inevitable necessity in an economy with inflationary tendencies.

## 6. THE RATE OF INTEREST

### (a) *Determination of the Rate of Interest*

In most countries, or at least in all countries with a developed economy, the rate of interest is fixed by the free interplay of economic forces. Nevertheless, the central banks do attempt to influence the debitory rate of interest, especially on short term credits, mainly through changes in the re-discount rate and other measures designed to influence the ability of the banking system to grant credit. Generally, a course of action designed to raise the interest rate is considered anti-inflationary, while policies aimed at lowering the interest rate are intended to increase the level of incomes and of economic activity. Though the last decades have witnessed a growing scepticism in the efficacy of changes in the rate of interest as a powerful means of influencing the level of income and economic activity, the re-discount rate was raised by many countries during the period after World War II and especially after the outbreak of the Korean War; this was introduced in each case as an anti-inflationary measure. To the extent that it is possible to judge the effectiveness of this step from developments in the economy of the countries concerned, the experiment of using the rate of interest as one of the instruments for influencing the levels of economic activity, incomes and prices appears, in many cases, to have proved successful.

A flexible rate of interest is thus a tool which the monetary authorities can use to influence the level of a country's economic activity. In most countries, there is no law fixing the maximum legal rate of interest. Indeed, even those central banks empowered by law to determine this maximum rate (e.g. in Burma and Ceylon) have not utilised this power, preferring to influence the interest rate by economic means. The low interest rates prevalent in many countries are not caused by legal restrictions but by economic circumstances.

(b) *The Ottoman Law of Interest in Israel*

At the time of writing, the debitory rate of interest in Israel is legally restricted by the Ottoman Law of 9 April 1887. This law, however, lacks effective penalties, and only prevents the law courts from issuing verdicts in favour of creditors who have lent money at interest rates higher than 9 per cent per annum; the latter rate is thus regarded as the legal maximum. The law further states that the court must always reduce an amount in dispute until it conforms to the legal rate of interest, even in cases where a higher rate has been explicitly mentioned in the loan agreement, or implicitly included in it by increasing the amount of capital due for repayment, or in other ways. The Ottoman law also forbids the collection of interest payments in excess of the amount of the original loan, regardless of the period for which the loan is given, as well as the charging of compound interest, except in a few specific cases. The application of this last restriction to Israel banking institutions was abolished by the Interest (Legal Rate) Ordinance 1929, on the express condition, however, that the interest rate must not exceed 9 per cent per annum.

The Ottoman Law of Interest is the result of the economic and social conditions existing in the Ottoman Empire at the time of its enactment. The economy of the Ottoman Empire was primitive, its banking system undeveloped and the majority of borrowers, especially the peasants, had recourse to usurers. The Ottoman Law of Interest was therefore designed to protect the borrower against usurers, as did the interest and usury laws of earlier times, rooted as they were in religious and social traditions.

The Ottoman law has many legal and administrative deficiencies: firstly, it includes no definition of interest, though the Loans at Usurious Interest Ordinance 1934 provides that the magistrate is free to regard a payment as interest "regardless of whether such interest was described in the agreement as interest, as principal, or its payment was demanded in a different way". Secondly, according to the same Ordinance, only the borrower, and no third party of any kind, is entitled to sue the lender. Thirdly, the law contains no effective penalties, apart from the provision that, should it be proved that too high a rate of interest was agreed upon between the parties, "the rate will be reduced to 9 per cent per annum".

Until 1952, there were, on the whole, no complaints about interest charges exceeding 9 per cent per annum on ordinary loans, whether granted by banks or otherwise. This was not due, however, to the effectiveness of the Ottoman Law of

Interest but chiefly to the economic conditions existing at the time, under which a rate of 9 per cent per annum or less was a reasonable equilibrium.

*(c) Loans at Illegal Rates of Interest and their Volume*

The phenomenon of loans at a rate of interest exceeding 9 per cent per annum began to appear in 1952, becoming widespread in 1953 and later years. This is essentially the outward symptom of a disequilibrium between the demand for and the supply of credit at an interest rate of 9 per cent per annum. In other words, the supply of credit at 9 per cent per annum cannot satisfy the whole demand for credit at this rate.

Credit at illegal rates of interest was given, in part, by financial bodies and private lenders, mainly in the form of discounts on bills of exchange, but partly also by banking institutions, which collected various payments from their debtors designed to camouflage an interest rate exceeding 9 per cent per annum.

It is difficult to establish the amount of credit granted at illegal rates of interest; but certain facts enable us to estimate the proportion of such credit within the total volume of credit in the economy at the end of 1955. The banking institutions which provide the largest share of total credit receive interest not exceeding 9 per cent per annum. Other banking institutions also give a part of their credits at 9 per cent per annum, including all credits granted through exemptions from liquidity requirements of re-discounts with the Bank of Israel. There is thus certain evidence for supposing that the proportion of credit at illegal rates of interest at the end of 1955 did not exceed 15 per cent or, at the very most, 20 per cent of credits granted by banking institutions from their own resources, which totalled IL.234 millions. In addition, credits totalling IL.104 millions at the end of 1955 were granted through the banking system from Government deposits. Most of these were long term loans from the Development Budget, at rates of interest varying between 6 and 7 per cent per annum.

Outside the banking system, credits were advanced by private lenders and financial bodies, generally at rates of interest fluctuating between 15 and 24 per cent per annum, in accordance with the degree of risk incurred and the redemption rate of the loan. Though no reliable data are available about such credit, there is every indication that its volume, in relation to the volume of bank credit, was small.

*(d) Reasons for the Level of the Rate of Interest*

An interest rate of 9 per cent per annum on short term loans granted against good security, exceeds the rate of interest in force in many countries, particularly in developed countries. The reasons for the high level of the rate of interest in Israel are to be found in those economic factors that determine the conditions of supply of and demand for credit. The more important of these factors are as follows:

(i) The expectation that prices will rise. Except for short periods, rising prices have been an almost permanent feature of the economy

from 1939 until the present day. It is, therefore, small wonder that a constant fear of a fall in the value of money has been implanted in the minds of borrowers and lenders alike. Although there has been a significant slowing down in the rate of price increases during the past two years, this factor still operates. When a rise in the price level is expected, the lender demands compensation for the risk that, when the loan is redeemed, the value of the interest paid and of the principal repaid will have fallen; even the borrower takes this factor into account. Thus, a disparity is created between the nominal rate of interest, which includes compensation for the risk of a fall in the value of the currency, and the real rate of interest.

(ii) **The low level of savings.** Since the inclination towards saving is weak, the supply of loanable funds is small in relation to the demand. (Saving is discussed in Chapter XVI).

(iii) **The strong tendency towards investment.** The strong tendency on the part of both public and private bodies to undertake large scale investments is one of the most typical characteristics of Israel. This tendency has been widely encouraged since the achievement of Statehood, especially in connection with the requirements of immigrant absorption. It does, however, often cause large sums to be invested without adequate capital resources. This, in turn, leads to the constant necessity for obtaining credit, both for financing the investment itself and for the working capital required for current production. In this manner, the demand for credit becomes relatively strong, even at interest rates higher than in other countries.

These three factors were operative during Israel's first years of independence, but they were later reinforced by two other factors which brought about the high rates of interest charged by a part of the banking system, as well as outside it.

(iv) **Restriction on bank credit.** The restrictions on credit, set out in Chapter XV, reduced the rate of increase in the supply of bank credit and of money. Though these restrictions were undoubtedly one of the direct causes of illegal rates of interest, it may well be that, indirectly, they prevented an even greater rise in the rate of interest which would have resulted from considerable inflationary pressures within the economy.

(v) **Illegal rates of interest on marginal credit.** Since most credits are granted at interest rates not exceeding 9 per cent, the majority of borrowers pay high interest only on their marginal credit. The larger the proportion of credit received at the relatively low rates, the better is the borrower able to pay a high rate of interest on the remainder, without raising the average rate of interest to any appreciable extent. For example, research\* into the financial situation of the *kibbutzim* (communal settlements) showed that in 17 *kibbutzim* the proportion of loans on which interest was paid at rates exceeding 10 per cent per annum, amounted

\* A summary of this research, carried out by Dr. I. Loewe, was published in the Bank of Israel Bulletin No. 2, December 1955.

to 15 per cent of all credits that they had received in 5714 (1954). The average rate paid on loans at illegal rates of interest was 15 per cent per annum; but there were some *kibbutzim* which paid interest at 20 per cent per annum and more. Nevertheless, the average rate of interest paid by *kibbutzim* on their loans in 5714 was far lower than this, and amounted to 7.7 per cent per annum in old established *kibbutzim*, 5.6 per cent annum in *kibbutzim* in the process of consolidation and 3.0 per cent per annum in new *kibbutzim*. There are indications that the proportion of loans at rates of interest exceeding 10 per cent per annum increased after 5714. It is also likely that the average rate of interest paid on credits in other branches of the economy is considerably higher than that paid by *kibbutzim*.

In any case, the average rate of interest paid by most enterprises is very considerably lower than the illegal rate charged on the marginal credits received. Other things being equal, the lower the rate of interest paid on the majority of loans, the higher the illegal rate paid on the remainder.

(e) *The Undesirable Effects of the Illegal Rate of Interest*

The existing rate of interest has given rise to a number of undesirable phenomena:

(i) Such undertakings that receive a relatively large part of their loans at a high rate of interest, naturally increase their production costs. In general, however, this factor is of minor importance, as interest payments usually constitute a small proportion of total expenditure on production. For example, in 5714, the interest paid by *kibbutzim* constituted, on the average, only 4.6 per cent of the value of their output. In the case of *moshavim* (smallholders' villages), this proportion was even lower, since less credit is required by them. Nor, on the whole, is the share of interest payments in total production costs relatively high in industry. Indeed, the rates of interest paid by some undertakings on marginal credit affect production costs only to a small extent. Their influence on the price level is smaller still, as prices are determined not only by production costs, but also by the demand for the commodity produced.

(ii) Though the share of interest payments in the total cost of production is low in enterprises or agricultural settlements which take up many loans at a high rate of interest, the influence on the profit margin may be considerable.

(iii) The situation created by the present legal restrictions on interest gives rise to a certain discrimination against such banking institutions as carry out the Ottoman Law of Interest to the letter. Other institutions, which receive a higher rate of interest on their loans and pay a higher interest on their deposits, tend to benefit. However, in practice, this fact has not hitherto resulted in the accruing of increased deposits in those banks that evade the law.

(iv) The existence of illegal rates of interest is undesirable for social reasons.

The level of the free rate of interest in Israel is determined by strong economic forces and its reduction therefore depends on changes in these forces. Greater stability of the price level and the currency is one of the most important pre-conditions of

a fall in the interest rate. The resultant feeling of confidence in the currency would reduce the gap between the nominal and real rates of interest and thus encourage saving. This, in turn, would improve the supply of credit without creating new money. An attempt to reduce the rate of interest by expanding bank credit, without offsetting such an expansion by additional saving, is, however, fraught with grave inflationary dangers to the economy. It is possible that such a move might even lead to a rise in the interest rate owing to the increased expectation of rises in the price level.

(f) *The Re-Discount Rate and the Rate of Interest*

The debitory rate of interest is, in many countries, largely governed by the re-discount rate of the central bank; hence, the central bank is able to use the re-discount rate as a valuable instrument for determining the debitory rate of interest.

The re-discount rate of the Bank of Israel for transactions in Israel currency was fixed in 1955 at 6 per cent per annum. The loans granted by banking institutions to the public against such re-discount carried interest at 8.5 per cent per annum, including commission and all other services. However, no close relation has, as yet, been created between the re-discount rate and the general debitory rate of interest. Despite the fact that the banking system showed every readiness to avail itself increasingly of re-discounting facilities, the Bank of Israel, fearing an undue expansion in the volume of credit and the money supply, severely restricted the amount of re-discounting it was prepared to undertake. (A detailed description of the re-discounting policy of the Bank of Israel is given in Chapter XVIII). The restricted volume of re-discounts, amounting to only 4 per cent of total bank credit at the end of 1955, considerably reduced the influence of the re-discount rate on the general debitory rate of interest, although it brought about the limitation of the interest rate on such loans as were granted against re-discounts.

(g) *Legal and Administrative Action*

The activities of the Bank of Israel during 1955 was mainly directed towards ensuring a high level of output and employment, as well as to the maintenance of relative stability. One of its subsidiary objectives was an eventual fall in the rate of interest. As a result of the economic conditions prevailing in Israel, it was impossible at this stage and on a short-term basis to reduce the interest rate by economic means and the Bank therefore examined the possibilities of dealing with this matter in other ways.

Section 78 of the Bank of Israel Law states that "the Ottoman Law of the 9th Rejab, 1304 (9 April 1877) and the Interest (Legal Rate) Ordinance shall not apply to banking institutions". On the other hand, the Governor of the Bank of Israel is empowered to fix the maximum debitory rate of interest for banking institutions in a law to be published after consultation with the Advisory Committee and after approval by the Government and the *Knesset* Finance Committee (Section 56 of the Bank of Israel Law).

The Bank of Israel was thus free to act in several ways:

(i) It could enforce Section 78 of the Bank of Israel Law, which rescinds the application of the Ottoman Law of Interest to banking institutions, without making use of Section 56 for regulations limiting the rate of interest that such institutions are permitted to charge.

Such a course of action would result in the rate of interest being fixed by the free interplay of economic forces and would possess several important economic advantages. A freely determined rate of interest would bring about an equilibrium between the supply of and the demand for credit, thus reducing the demand for loans and even enabling banking institutions to raise the credit rate of interest on deposits and savings. Indeed, it may well be that such a step would have strengthened the anti-inflationary tendencies in the economy. However, as the cancellation of existing legal restrictions would have led to an increase in the debitory rate of interest charged by those banking institutions now implementing the Ottoman Law of Interest, production costs in the economy as a whole would have risen to a certain extent. Moreover, doubts of a political and social nature arose as to the suitability of the present time for the creation of a legal vacuum with regard to the interest level, since the Israel public has, over several decades, been accustomed to legal restrictions on the interest rate. It was therefore decided not to rescind the application of the Ottoman Law of Interest to banking institutions without substituting some other legal limitation.

(ii) It could enforce Section 78 of the Bank of Israel Law and issue regulations limiting the debitory rate of interest in banking institutions, in accordance with Section 56.

Grave doubts arose, however, as to the efficacy of such regulations. If the rate of interest fixed by the regulations were lower than the rate ensuring equilibrium between the demand for and supply of credit, continual pressure would be exercised for the easing of the credit restrictions and many ways of circumventing the new regulations would undoubtedly be discovered, thus rendering its effective implementation extremely difficult. Moreover, success in enforcing regulations of this kind on banking institutions (the breaking of which carries the penalty of a year's imprisonment, a fine of IL.1,000, or both, in accordance with Section 73 (c) of the Bank of Israel Law) is unlikely, while other financial bodies and individual lenders would not be subject to punishments of this type for breaking the Ottoman Law of Interest.

As a result of these considerations, the Bank of Israel came to the conclusion that, for the time being, it is advisable to maintain the application of the Ottoman Law of Interest to banking institutions. For this purpose, the Bank proposed to the *Knesset* that it amend Section 79 of the Bank of Israel Law, which states that all sections of this Law "shall come into force not later than one year from the day of its publication in the Official Gazette", i.e. on 3 September 1955. Indeed, in accordance with the Government's recommendations, the *Knesset* decided on 1 September 1955

to amend Section 79 of the Bank of Israel Law, so that all Sections of the Law would take effect on 3 February 1956.

In subsequent discussions, the Government gradually reached the opinion that the settlement of the interest problem necessitated the enactment of a general law of interest, which would apply both to banking institutions and to all other borrowers and lenders. This decision was announced by the Minister of Finance in the *Knesset*, which accordingly amended Section 79 of the Bank of Israel Law once more during its meeting of 19 Shvat 5716 (1 February 1956). By virtue of this amendment, all Sections of the Bank of Israel Law, including Section 18, will come into effect on 3 August 1956.

At the time of writing, the Government is examining the various possibilities of solving the problem of interest.