

CHAPTER XIV

MAIN DEVELOPMENTS IN THE MONETARY SYSTEM

THE DEVELOPMENT of the monetary system in Israel and the policies of the Bank of Israel can be understood only against a background knowledge of the general conditions characteristic of the country's economy. Hence the analysis of monetary developments in 1956 will be preceded by a summary review of these conditions.

1. THE CAUSES OF EXCESSIVE CREDIT DEMAND

A very strong tendency towards constant expansion prevails in the Israel economy. This has its roots in several basic factors: the rapid growth of the population; the continuous absorption of new waves of immigration, often coming from underdeveloped countries, which necessitates vocational training in accordance with the requirements of the economy; the high technical level of the entrepreneurial elements operating in the country, which facilitates an efficacious absorption of large quantities of capital equipment; the development of uninhabited regions; the general striving towards the extension of social services and an ever-rising standard of living; the desire to maintain a state of full employment; the experience of prolonged inflation, and the economic burden of defence expenditure. All these and similar factors have instilled in public institutions, companies and individuals a strong desire to employ additional resources.

Such a tendency towards rapid expansion is an important economic asset, but it has consequences which require careful examination. In a young economy, in which the accumulation of capital by firms and individuals is inevitably very small in comparison with the resources which they desire to have at their disposal, no attempt can be made to acquire these resources unless credit is provided. Hence, a great demand for credit is instigated, both for long-term loans, for investments in equipment, housing, or durable consumer goods; and for short-term advances for working capital, i.e. for the financing technically necessary to facilitate normal production and marketing processes, or for the accumulation of inventories.

A further stimulus to the demand for credit derives from the fact that its price, i.e. the rate of interest, is usually fixed not by the free interplay of supply and demand, but—in most cases—by law. Moreover, the credits of the Government and the Jewish Agency, whose share in the lending of long-

term loans is overwhelming, are granted at relatively low rates of interest. One of the forms of an effectively low interest, which may sometimes even become negative interest, derives from the granting of long-term loans without a purchasing power guarantee or with a partial guarantee only, during periods of a general expectation of a rising price level.

2. THE LIMITS OF EXISTING RESOURCES

The great demand for credit is based on the assumption that the extra credit will provide its recipients with control over additional goods or factors of production. But while this assumption may be valid for an individual undertaking, or even for a group of undertakings, it cannot under present circumstances be regarded as valid for the economy as a whole except up to a certain point, because there is only a limited amount of additional real resources which can be employed immediately.

The supply of additional goods or factors of production may originate from capital imports, or may be forthcoming from the employment of previously idle resources or from the creation of new ones in the process of economic growth.

The volume of capital imports is largely determined by external factors and is necessarily limited. On the other hand, there are very few idle resources which might be employed with little delay by an increase of total demand.

The existence of unemployment, to the extent of several tens of thousands, frequently leads to exaggerated estimates of idle production capacity in the economy. Some of these unemployed represent a hard core created by the difficulties of adjustment to the social and economic structure of the country¹. Others represent the temporary frictional unemployment of people in transition between industrial sectors or between localities. This is bound to be greater than elsewhere in a country of mass immigration. While there is a certain amount of unemployment among unskilled workers, skilled labour is in very short supply in a large number of branches. The existing wage structure, with its small differentiation between skilled and unskilled workers and between industries, impedes desirable processes of greater vocational specialization and labour mobility, as may be required by changing economic conditions. Even an increase of total demand would most probably provide jobs only for part of the unemployed workers at present wage rates. There may also be a certain amount of not fully exploited plant and equipment. But even were labour and equipment to be employed as fully as feasible, it would not be possible to expand real output—apart from that of certain services—without utilizing

¹ See Chapter VIII, above.

additional raw materials. But it is exactly the supply of these which is very limited in Israel and cannot be increased without expanding imports.

Even if it were possible to expand output to a certain extent in a few branches, its effect on the general level of demand would have to be taken into account. An increase in the output of an industry naturally provides income for the production factors which contributed to its creation. The overwhelming proportion of this income, or—if nothing of the increment is saved—all of it, is spent on consumption. This additional demand in its turn creates new income, and the raising of output in one industry thus causes a chain reaction of additional income generating new demand and *vice versa*. Even if in the first stages of this process the larger demand calls forth an increase in real output, in subsequent stages there will be no possibility to go on expanding production in an economy approaching full employment. Consequently, disequilibrium will occur at the existing price level. This disequilibrium can be counteracted without raising local prices by increasing imports, regardless of whether these latter are production factors for the original expansion of output, or goods for the satisfaction of the additional demand thus created. In any case, increases in output will—directly or indirectly—almost inevitably lead to an expansion of imports².

The driving force behind the process of increasing demand is the expansion of the money supply, i.e. the expansion of credit³.

The result is an inflationary development, with all its undesirable concomitants such as the inequitable distribution of the inflationary burden between the various strata of the population, the decline in the willingness to save,

² Even if all the additional local output is exported, the net improvement in the balance of payments will be smaller than the gross increase in the output for export. For the additional earnings of the factors of production participating in the expansion of export (i.e. of the exporters and the labour directly or indirectly employed by them) will increase the total income of the economy considerably, and some of this income will inflate the demand for imported goods or local goods comprising an import component. Under prevailing conditions, the import component of additional demand is probably quite large and a considerable proportion of the extra foreign currency accruing to the economy from export—and in certain circumstances even all of it—is therefore likely to be spent on additional imports. The real output of the economy will in this case have risen, but without significantly improving the balance of payments. That part of exports which does improve the balance of payments will be greater as more of the additional income from exports is saved, as more of the additional demand is diverted to local output, and as more local factors of production are idle and available for employment. The same applies not only to increases in output for export, but also to increases in output designed to cut down imports.

³ The chief factors directly responsible for the fluctuations in the money supply are changes in the total volume of credit and the conversion of foreign currency balances. While the extent of such conversions is mainly determined by factors beyond the direct control of the central bank, the bank has a considerable measure of power to fix the volume of credit, and this will therefore be treated here as the factor determining the size of the money supply. It is being assumed that the central bank also takes into account the effect of foreign currency conversion in this regard.

distortions in the pattern of production (causing waste of production factors and discouraging productivity), and the pressure it originates to increase imports, reduce exports, and thereby worsen the balance of payments.

From the aspect of these effects of inflation, it makes little difference whether the inflationary process was first set in motion by an expansion of credit which caused monetary demand to exceed supply at the existing price level (a "demand inflation") or whether it began by a rise in nominal production costs, accompanied by an expansion of credit which enabled the process to develop in order to prevent widespread unemployment and a fall in output (a "cost inflation"). The expansion of credit is a prerequisite for the development of either type of inflation, for cost inflation also cannot develop over an extended period without soaring unemployment—unless credit is expanded. As wages are linked to the price level by means of the cost-of-living allowance system, any rise in production costs is likely to develop into a protracted process of wage and price increases.

Since the Israel economy has gone through the experience of acute inflation, and its damaging results are well-known, the Government has in recent years made efforts to maintain a stable price level. Whenever an inflationary development was feared, the Government increased the real volume of imports, with the aim of retarding the upward movement of prices. This was done by relaxing import restrictions, and sometimes even through Government sales of imported consumer goods at comparatively low prices, designed to avert a rise in the consumers' price index and the consequent wage increases. Higher local demand also resulted in larger domestic consumption of export goods. In most other economies such a course would have come to an end after a relatively short period, as soon as available foreign currency balances were exhausted or once the practical limit of increased foreign indebtedness had been reached. However, capital imports into the Israel economy have grown considerably in recent years, and this made it possible to restrain price increases to a significant extent by balancing the anticipated surplus demand with a larger supply of imported manufactures and raw materials as well as of potential export goods. This expedient, to which the Government has resorted frequently in recent years, resulted in concealing from the public the dangers inherent in the excessive demand that follows an undue inflation of credit; support was thereby given to the illusion that credit can be expanded considerably without generating a demand in excess of available supply and thus initiating a process of inflationary price rises. The fact that large sections of the public are unaware of the risks involved in excessive credit expansion places great obstacles in the way of conducting a policy of restrained credit expansion, as desired by the Bank of Israel.

3. THE CRITERIA FOR THE DETERMINATION OF THE DESIRABLE RATE OF EXPANSION

One of the tasks of the central bank is to determine a rate of credit expansion which, while not causing a deterioration in the balance of payments, would increase employment and real output as much as possible. Indeed, the specific conditions prevailing in the Israel economy even require that credit policy be directed towards an improved external balance. For this purpose, the central bank must consider whether the economy possesses factors of production which could become employed by additional credit, and at what rate additional employable factors of production are likely to accrue in the future.

Moreover, the central bank must take into account possible fluctuations in the money supply caused by factors other than the volume of credit—for the influence of foreign currency conversion on the money supply and nominal incomes is much the same as that of credit expansion.

A further factor to be considered is the public's liquidity preference, i.e. how much of the additional money the public wishes to keep in the form of liquid balances due to precautionary motives, or due to the desire to save, and what part of the money supply is held for transactions. Changes in the public's liquidity preference as regards the existing stock of money must also be allowed for.

The determination of the rate of credit expansion by the central bank may be influenced by the existence of an excessive demand for credit on the part of the Government or the public. But such a course is fraught with danger. Unlike in the case of goods or services, it is well possible that larger supplies of credit will not satisfy demand, so that equilibrium will not be established between the amount of credit demanded and the amount supplied, for as long as the rate of interest in the economy is fixed, and not determined by the free interplay of supply and demand. In fact, it may well be that the very expansion of credit will stimulate further demands for additional credit at a later stage. This is liable to happen if the larger volume of credit augments demand, thus raising the price level, which in turn would continuously enlarge the "requirements" for money balances in order to maintain the desired level of production. It is an established fact that, despite the continuous expansion of credit in recent years, at a rate exceeding that of the real growth of output or of available resources, there are no signs of any decline in the excessive demand for credit.

4. THE CAUSES OF THE INCREASED DEMAND FOR CREDIT IN 1956

A number of factors have been operative, in particular during 1956, in swelling the demand for credit on the part of the Government and the public.

The Government's demand for credit was chiefly caused by the great in-

crease in its expenditure, while fiscal revenue and income from counterpart funds showed no corresponding rise. The increase in the Government's expenditure was mainly the result of two phenomena:

(a) *Defence Expenditure*

The large outlays on defence, which in part at least were unforeseen, yet could not be postponed, increased the expenses of the Government, local authorities and other public bodies.

(b) *Increased Immigration*

The larger influx of immigrants, and the fact that the new arrivals were provided with equipment and housing of a higher standard than in the past, also increased the outlays of the Government and the national institutions.

In addition, demand for more credit also arose in the non-governmental sector, chiefly as a result of the following factors:

(a) *Increase in Wages and Other Production Costs*

Money wages increased on the average by 13 per cent, and prices of imported materials also rose quite considerably. In order to maintain the existing level of production and employment at the higher level of monetary costs, producers and distributors required a larger volume of credit.

(b) *Expansion of Real Output*

Agricultural and industrial output increased greatly. This too stimulated the demand for credit.

(c) *Vertical Development of Local Production*

The change in the composition of local production—especially the expansion of industrial crops for local processing—also required larger amounts of working capital, in consequence of the longer period required to grow industrial crops as compared with other crops, and because of the need for storage of stocks in various stages of agricultural and industrial processing or marketing. Such storage requirements were smaller when the materials concerned were imported.

(d) *Unforeseen Accumulation of Stocks Due to the Sinai Campaign*

The temporary dislocation of the normal production and distribution processes during the Sinai campaign caused an unexpected accumulation of stocks by producers and distributors, with a resultant higher demand for money to finance such inventories.

5. THE CONVERSION OF FOREIGN CURRENCY BALANCES

As already mentioned, the central bank, in framing its credit policy must allow for the effect of foreign currency conversion on the money supply. The Bank of Israel has no direct control over the fluctuations in the volume of such conversions although it can exercise some indirect influence through the effects of credit policy on the balance of payments and on foreign currency balances.

In 1956 as a whole, conversion did not constitute an important factor as far as its effect on money supply was concerned, and the total increase resulting from it did not exceed IL.6 million. In the course of the year, however, conversion had a considerable influence on the fluctuations of the money supply. Large amounts of foreign currency were converted into Israel Pounds during the first half of 1956, particularly during the first quarter, and this was largely responsible for the variations in the money supply at the time. On the other hand, large-scale "negative" conversions took place during the third quarter of 1956.

6. THE CREDIT GRANTED TO THE GOVERNMENT

Another major cause of fluctuation in the money supply on which the Bank of Israel has only limited influence is the volume of credit granted to the Government.

As long as the extension of credit was directly connected with the extraordinary—and largely unforeseen—security expenditure, the Bank accepted it as unavoidable. At the same time the Bank made every effort to persuade the Government that large-scale recourse to bank credit, arising from the failure to restrict spending for low-priority purposes, cannot but result in grave damage to the economy.

The volume of bank credit granted to the Government increased considerably during the year, and this contributed to the increase of the money supply to the extent of some IL.76 million. This was entirely offset by the negative conversion of foreign currency by the Government to the amount of some IL.79 million. But it must be noted that this negative conversion was one of the causes of the deterioration in the balance of payments during the year.

For a clearer insight into the Government's influence on the monetary system, one must examine not only its relations with the banking system but also its financial activities vis-à-vis the public. An important part of Government expenditure (especially within the framework of the Development Budget) consists of loans granted for the financing of investments and—to a lesser extent—for the financing of current production in non-governmental sectors of the economy. On the other hand, the Government receives long-term loans

from the public and maintains ramified financial relations with suppliers of goods and services.

In Chapter XX, an attempt has been made to construct a framework of the financial relations between the Government and other sectors, including the public. The partial data available show that during the first three quarters of the fiscal year 1956/57 there was no increase in the short-term liabilities of the Ministry of Finance (chiefly to suppliers) but, on the contrary, there was actually a decline of IL.14 million. It therefore appears that, in so far as the financial activities of other Government departments did not have a contrary effect, the Ministry of Finance had no need, during the major part of 1956, to resort to additional borrowing from the public for the financing of its operations and even succeeded in reducing its current debt.

7. THE GROWTH OF SAVING

In 1956 numerous steps were taken by the Government and the Bank of Israel with the aim of encouraging a higher rate of saving. The most important of these activities was the issue of debentures linked to the exchange rate of foreign currency or to the consumers' price index, and the encouragement of various saving schemes sponsored by the banks or other bodies.

A total of IL.44.5 million worth of securities with a purchasing-power guarantee were issued between August, 1955 and the end of December, 1956⁴. The greater part of these issues was taken up by provident funds and financial companies, and only a small proportion by the public. In addition, some banks initiated saving schemes of their own. These and other forms of saving benefited from income tax concessions, while the saving schemes of the banks were also granted some privileges as regards credit restrictions.

It is difficult to determine how much of this saving were additional savings reducing current expenditure, and how much represented previously existing savings which had been re-invested in a new form. In so far as savings of this type were made from current income, the funds they mobilized served as non-inflationary financing of additional investments by the Government and other public bodies.

One of the effects of the various schemes designed to encourage saving was the reduction, to a minor extent, of the money supply. This influence was, however, limited, for though time deposits (including saving schemes in banking institutions) increased by IL.12 million during 1956, the investments of banking institutions in securities—also largely connected with their saving schemes—raised the money supply by IL.5.5 million. The saving schemes and time deposits also enabled banking institutions to expand credit somewhat, as will be described below.

⁴ Excluding the Defence Loan.

8. THE CREDIT GRANTED TO THE PUBLIC

The chief instrument of the Bank of Israel's operations in 1956 continued to be its control over credit granted to the public. Certain important factors, which swelled the public's demand for credit during the year, have already been described. Some of these factors were connected with the considerable rise of the wage level. To prevent the spread of unemployment which would have resulted from a refusal to expand credit, the Bank acceded to a limited extent to some of the public's demands for additional loans which originated in the increase of production costs⁵.

The Bank also deemed it desirable to assist the financing of agricultural and industrial output through the employment of new factors of production which had accrued to the economy, particularly in cases where the additional output was destined for export or constituted a direct substitute for previously imported raw materials or manufactures.

While the Bank considered that a sizeable expansion of credit to the public had become unavoidable, it endeavoured at the same time to mitigate its undesirable effects by channelling the additional credit to industries and to products possessing a high degree of priority with regard to the improvement of the balance of payments. However, this selective control of credit cannot in itself neutralize completely the undesirable results of excessive credit expansion. For—already at the second remove—the additional credit becomes the income of various factors of production, such as workers and suppliers. The additional demand thus generated is then directed to goods and services in general. Nevertheless, qualitative credit regulation is capable of encouraging the expansion of industries or the production of certain commodities currently possessing a relatively high priority from the view point of the economy as a whole.

(a) *Methods of Credit Expansion*

The Bank had the choice of several methods to implement the expansion and direction of credit: it could maintain the quantitative restrictions on the expansion of credit by banking institutions, and supply the additional credit through re-discounts. This method has the advantage of ensuring the strict implementation of selective credit controls in the initial stage. However, it not only makes it possible to expand credit without lowering the liquidity ratio of the banking institutions, but even increases this ratio by supplying the banks with additional reserves, reinforcing their demands for an expansion of credit. Another method open to the Bank was to permit the banking institutions to expand credit from their own resources.

The liquidity position of the banking institutions became considerably stronger in 1956. This was chiefly the result of the expansion of credit to the

⁵ As noted in previous chapters of this report, a big increase in unemployment was also averted by the expansion of credit to the Government.

Government and the increase in time deposits and, during the first of the year a consequence of foreign currency conversion.

The Bank of Israel, therefore, often preferred to allow the banking institutions to supply the economy with the additional credit from their own resources. This was done partly by increasing the permissible amount of bank advances by 3 per cent, partly by permitting institutions possessing a liquidity ratio of more than 50 per cent to increase their advances to the extent of 40 per cent of their surplus liquidity, and partly by authorizing banking institutions to expand credit to the extent of 40 per cent of the saving schemes instituted by them. However, the banking institutions were required to obtain the specific authorization of the Bank of Israel for all loans so granted, so as to ensure that the additional credit was channelled to high priority purposes. In addition, the volume of re-discounts⁶ was increased in 1956 mainly during periods when no arrangements for expanding credit from the resources of the banking institutions were in force. Re-discounts by the Bank of Israel were also used as a means of granting credits to encourage exports and carried an interest rate of only 5 per cent per annum.

(b) *The Extent of Credit Expansion*

The total volume of credit granted to the public in local and foreign currency expanded by IL.43 million during 1956—an increase of 17 per cent. Of this additional credit, 55 per cent were granted from the resources of banking institutions, and the remaining 45 per cent through re-discounts by the Bank of Israel.

Credits in Israel currency accounted for IL.36 million of the extra credit to the public, while approximately IL.7 million were granted in foreign currency loans. Most of this new credit was directed to agriculture and industry and the share of these two sectors in total outstanding credit balances rose considerably. The shares of the other economic sectors did not increase and credit for building even contracted both relatively and absolutely, despite the higher costs of production in this sector. Selective credit controls served as a major instrument for the encouragement of agricultural and industrial production—especially for export—and for the restriction of the building volume for persons other than immigrants.

(c) *The System of Credit Control*

The deficiencies of the existing system controlling the volume of credit, which have already been described in the Annual Report of the Bank of Israel for 1955,

⁶ As the liquidity ratios of some banking institutions were comparatively high, re-discounts only partly served to increase their reserves and thus enable them to expand credit, as is customary in other countries. The function of re-discounts in Israel is partly to enable the extension of credit by the Bank of Israel, but through the intermediary of the banks, for purposes of high national economic priority.

were even more conspicuous during 1956. This system is based on regulations which were issued from time to time in the past, and consists of liquidity requirements ranging up to about 90 per cent, in accordance with the sum of deposits held at various base dates. Other instructions determine the maximum sum which may be lent, according to the balance of outstanding loans on a certain date ("credit ceiling" regulations).

The definition of liquid assets in fact includes assets of low liquidity, such as the 3% Government Loan. The banking institutions have been required to invest a fixed percentage of their deposits in this loan, which is not negotiable into cash except by special arrangements applicable in the event of a decline in deposits. Moreover, the liquidity regulations do not distinguish between local and foreign currency, neither as regards deposits nor as regards liquid assets. In addition, the system has a large number of other loopholes. The present system of controls is, therefore, both cumbersome and rigid. Furthermore, banking institutions whose deposits had risen during recent years to a greater extent than those of other banking institutions, were unable to expand credit, and their liquidity ratio thus rose involuntarily above that of other institutions.

During 1956, the Bank continued to examine the possibilities of modifying the liquidity regulations. Proposals for their simplification were worked out with the objective of converting the regulations into a flexible instrument, permitting changes in liquidity ratios where necessary and providing a major tool for adjusting the volume of credit. At the same time, the introduction of more uniform liquidity ratios for the various banking institutions was sought.

The Advisory Committee of the Bank of Israel discussed the simplification of the liquidity regulations during the year, but has not yet formulated its conclusions. Nevertheless, after consulting the Committee, the Bank decided upon the immediate adoption of certain measures in this direction. One of these was the decision to allow all banking institutions whose liquidity in Israel currency exceeds 50 per cent to expand credit to the extent of 40 per cent of the excess; in the interest of selective credit control, such credits can, however, only be granted with the specific approval of the Bank of Israel.

9. THE RESULT OF THE EXPANSION OF THE MONEY SUPPLY

The money supply increased by 23 per cent in 1956. This development was caused by the expansion of credit to the public and to the Government, and to a lesser extent, by the conversion of foreign currency balances. The average volume of the money supply was 18 per cent larger than in 1955. As stated above, the increase in the money supply was partly due to the desire to prevent unemployment as a result of wage rises and increases in other production costs. Viewed from this aspect, the monetary expansion permitted the development of a cost inflation. On the other hand, it also enabled the

Government and the public to expand their real demand for goods and services, thus constituting an autonomous factor of a demand-induced inflation.

A considerable part of the additional demand in the economy was balanced by the larger supply of goods and services from domestic output, which was about 8 per cent higher than in 1955. Nevertheless, imports were also expanded, partly in order to retard the upward movement of prices. The bigger volume of local output could not have been achieved without the sizeable increase in unrequited receipts and current revenue from abroad. It was also necessary to increase the foreign debt, and *inter alia*, short-term foreign liabilities. In 1956, the real increase in the sum total of resources available to the economy amounted to about 10 per cent⁷, while the average price level appears to have risen by some 8 per cent. These price increases, together with those of former years, are inevitably reflected in a growing pressure on the balance of payments.

⁷ Part of the increase in resources is due to the larger imports of services by the Government, which do not enter the local market. With regard to these, the domestic money supply does not constitute a means of exchange.