

## CHAPTER XIII

### MAIN DEVELOPMENTS IN THE MONETARY SYSTEM

INFLATIONARY TENDENCIES were in evidence in the Israel economy in 1957, since monetary demand increased at a rate which exceeded the rate of increase in real output. As a result, imports increased and prices rose considerably (8 per cent). These developments slowed up a possible improvement in the balance of payments.

Inflationary developments were mainly the result of the rapid increase in the money supply, the average level of which exceeded in 1957 that of the previous year by 20 per cent. The two main reasons for the increase in the supply of money were, first, the large expansion of bank credit to the Government required for increased repayment of debts contracted during the Sinai campaign, in the early part of the year. Expenditure on the intensified public building construction following an increase of immigration was the reason for the need for extensive bank accommodation at the end of the year. The second reason for the increase in the money supply was the constant expansion of credit to the public.

Monetary developments in 1957 were the result of several factors which operated at varying degrees of intensity during the year. To describe these developments, it will be convenient to divide the year into thirds even if this procedure, like similar divisions of this character, may seem rather arbitrary.

During the first third of 1957, credit granted to the Government by the Bank of Israel was considerably expanded. The increase in credit to the Government was not connected with intensified Government demand during that period, but was the result of payments to the public for goods and services which the Government purchased from it at the time of the Sinai campaign. Thus, the increase in credit mainly influenced the public's liquidity. As additional revenue from taxes and other receipts from the public and from abroad only partly covered this expenditure, it entailed large-scale deficit financing, both at the end of 1956 and in the early part of 1957.

The large expansion of credit to the Government was accompanied by a considerable increase in foreign exchange reserves. During the first third of 1957, balances of foreign exchange rose by IL. 22 million. This was a seasonal rise which corresponded with fluctuations of these balances in the same period in previous years.

The substantial increase in bank credit to the Government and the seasonal increase in foreign exchange balances in the early part of 1957 were not wholly offset by other factors which contribute to the reduction of the money supply.

Moreover, during this period, there was also an expansion of credit to the public—by IL. 9.2 million. This expansion occurred in spite of the reduction in rediscounts, and was due to the increase in accommodation to the public from the means of banking institutions. A similar expansion occurred during the corresponding months of previous years, and it may be considered a seasonal phenomenon. The reason for this is that banking institutions generally refrain from expanding credit during the last months of the calendar year, prior to drawing up their annual balance sheets. In the early part of the year, accommodation is expanded once more. However, in 1957, these seasonal fluctuations were more accentuated, as a result of the decline in the liquidity of banking institutions by the end of 1956 due to the increase in withdrawals during the Sinai campaign, when banking institutions were prevented from expanding credit. However, when cash was redeposited in the early part of 1957, their liquidity was increased and thus the expansion of credit was rendered possible. Hence, in the first third of the year, the increase in balances of foreign exchange and the expansion of credit to the public were, in part, seasonal phenomena. However, the large credit expansion to the Government at the end of 1956 and in the early part of 1957, due to increased defence expenditure, cannot be ascribed to seasonal factors.

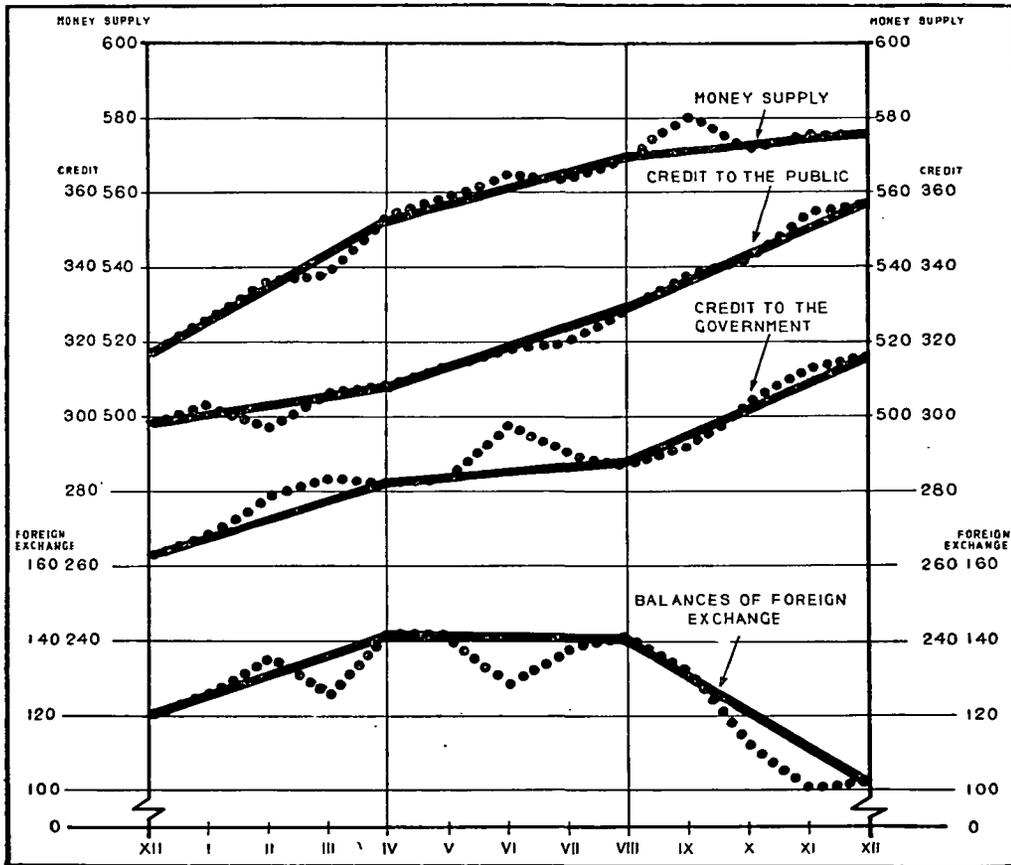
Owing to the expansion of credit to the Government, to an increase in foreign exchange balances and in credit to the public, the supply of money rose during the first third of 1957 by IL. 36.8 million—an average monthly increase of 1.8 per cent. Furthermore, it would seem that, early in 1957, the alleviated security situation following the Sinai campaign led to renewed cash outlays by the public. It will be remembered that the public refrained, owing to precautionary motives, from spending cash during the period preceding the campaign. Thus, at the beginning of 1957, the public increased its current purchases, in particular of apartments.

These were the factors which largely contributed to the intensified economic activity in 1957, already in evidence during the first months of the year and which is analyzed in greater detail in other chapters. The accelerated economic activity led to an increase in the public's demand for bank credit. On the other hand, there was an increase in the liquid assets of banking institutions, due both to the expansion of credit to the Government and to an increase in foreign exchange reserves. Another reason was the public's preference in 1957, contrary to 1956, for bank deposits instead of cash. In the early part of 1957, the Bank of Israel authorized banking institutions to expand credit to agriculture and to industry, provided that they held liquid assets in excess of 50 per cent (this rate was reduced to 40 per cent from September 1957). As a result, the considerable expansion of credit—of IL. 21 million—to the public was rendered possible between May and August. In these months, bank credit to the public was the main factor responsible for the increase in the money supply. During this period, credit to the Government increased by only IL. 5 million, and the amount of foreign exchange balances remained almost unchanged. Between May and August the

money supply increased by IL. 16.8 million or at a monthly rate of 1 per cent. Thus, the money supply continued to rise during the second third of 1957, although its rate of increase was lower than during the first four months of the year.

DIAGRAM XIII-I

*The Money Supply, Credit and Balances of Foreign Exchange*  
(millions of IL.)



Credit to the public was considerably expanded during the last four months of 1957. The main increase was due to rediscounts at the Bank of Israel, while the rate of increase in credit from the means of banking institutions declined. Moreover, during this period, credit to the Government was also expanded by IL. 30 million. This was connected with the financing of the increased public building construction due to increased immigration. During this period income of

the Development Budgets lagged behind the budget estimates. As a result, the Government had to resort to considerable deficit financing.

The simultaneous expansion of credit to the Government and to the public could have led to a large increase in the money supply. However, during the four last months of the year, the increase in the money supply was only IL. 6 million or 0.3 per cent. The reason for this was the decline in foreign exchange reserves.

The accelerated economic activity entailed an increase in civilian imports to satisfy the increase in demand. Towards the end of the year, this increase led to a considerable decline in foreign exchange reserves—of IL. 40 million—which had risen at the beginning of the year. Although the decline of reserves at the end of the year is a seasonal phenomenon, its rate of decrease during the period under review was greater than in former years.

Time deposits rose continuously over 1957 as a whole. This slowed down the rate of increase in the supply of money by IL. 38.6 million. A considerable part of the increase in time deposits was shown by the accounts of saving schemes operated by a number of banks. These schemes attracted the public because of their interest rates—5 to 6 per cent—and also owing to the tax relief granted on such deposits. At the same time, banking institutions tried to encourage these schemes because they were anxious to attract deposits of a less liquid nature; and also, because the rate of liquid assets to be held against these deposits is lower than that required for demand deposits. It may well be that part of the increase in time deposits was due only to a transfer from demand deposits not intended for current expenditure in any case. The increase in time deposits, therefore, only partly indicated an increase in savings out of current income.

## 1. CREDIT CONTROL

Theoretically, there was no change in the method of credit control, as the regulations relating to liquidity rates and the volume of credit<sup>1</sup> remained unchanged in 1957. However, in practice, the Bank of Israel resorted to greater reliance on minimum liquidity rates as the main instrument of the quantitative limitation of credit. Already at the end of 1956, banking institutions were authorized to expand credit subject to the approval of the Bank of Israel, provided that their liquid assets<sup>2</sup> exceeded the required 50 per cent. In May 1957, this rate was reduced to 45 per cent. In September 1957 banking institutions which held liquid assets in excess of 40 per cent were authorized to expand credit up to this rate. This additional credit had also to be approved by the Bank of Israel and was

<sup>1</sup> For further details, see Annual Report for 1955, page 175 and Annual Report for 1956, page 261.

<sup>2</sup> For this purpose liquid assets mean cash, gold and silver bars, net balances in banking institutions and in the Bank of Israel.

intended for the financing of high priority production. Thus, the regulations relating to the stabilization of the volume of credit became mainly an instrument of qualitative rather than of quantitative credit channelling.

The limitations to the liquidity regulations which determined graded liquidity rates in accordance with the amounts of deposits for different periods have been outlined in the Annual Report for 1956. New liquidity regulations in this matter were drafted in 1957 by the Bank of Israel; they only came into force, however, on the January 1, 1958<sup>1</sup>. The minimum liquidity rates fixed by these regulations are 58 per cent for demand deposits not exceeding 18 months, in Israel currency. However, the Bank of Israel is prepared to discount loans for the financing of high priority production at this liquidity rate, subject to its special approval and up to an effective liquidity rate of 38 per cent. These were the average rates prevailing at the end of 1957; they consequently did not call for any real change in the liquidity rates. However, the introduction of more effective regulations will contribute to an improvement of credit control, and it may eliminate some of the long-established deficiencies in this system.

Other measures to improve credit control during the period under review included the speeding up of cheque clearance. Already in 1956, the Bank of Israel, in collaboration with the banking institutions, made arrangements for accelerated urban cheque clearance. The results were felt in 1957 when the increase in balances in transit between banking institutions was checked. In former years this increase was a permanent factor tending to increase the money supply. In 1957, additional arrangements for the improvement of inter-urban clearing were made. They are designed to reduce even more the amount of balances in transit. These arrangements came into force at the beginning of January 1958<sup>2</sup>.

Furthermore, the Bank of Israel intensified control over the implementation of the credit regulations, especially for credit cooperative societies.

Until September 1957, credit to the public was expanded only from the means of banking institutions. Rediscounts were increased considerably only during the last quarter of 1957. The reason for this was the financing of operations outside the regular framework of ordinary credit extended by the banking institutions, such as the financing of a considerable increase in fuel stocks, and the substantial loan, in foreign exchange, to the Reparations Corporation destined for advances on account of orders from abroad.

<sup>1</sup> A detailed description of these regulations will be found in Chapter XIV, Money Supply, Credit and the Banking Institutions.

<sup>2</sup> For details of the arrangements made in this respect in 1956 see the Annual Report for 1956, page 271. A description of the clearance system drafted in 1957 will be found in Chapter XIX, The Activities of the Bank of Israel.

## 2. THE CHANNELLING OF CREDIT TO AGRICULTURE AND TO INDUSTRY

In 1957 the Bank of Israel also made overall arrangements under the system of credit channelling to ensure adequate finance for agriculture and industry. In accordance with an agreement with the Ministry of Agriculture, the Bank fixed a specified amount of advances to be granted for every dunam of cotton, ground-nuts, fodder and other field crops. In 1957, these advances rose as a result of the expansion in the cultivated area of those crops for which these advances were given; furthermore, these advances were extended to maize and hay. This credit expansion by the Bank was implemented by authorizing banking institutions to grant credit for these purposes from their own means provided that their liquid assets exceeded 40–50 per cent, as mentioned above, on one hand, and through rediscounts at the Bank of Israel, on the other hand.

Advances at specified rates were also given for production for export. Credit was extended either through banking institutions or through rediscounts. Government financing of production for export was made through special funds in banking institutions, derived partly from Government budgets and partly from the means of banking institutions.

It would appear that, in 1957, there was an improvement in the liquidity position of agriculture and industry. This was the result of the considerable credit expansion to these sectors, and also of the higher profits made by agriculture and industry following output and price developments described in other chapters of this report. In agriculture, the consolidation loan for short-term debts granted by the Government to certain kibbutzim, constituted an additional reason for an improvement in the financial position.

## 3. THE LAW OF INTEREST

In March 1957, the Law of Interest came into force, repealing thereby the former Ottoman law. In accordance with the authority conferred upon him by this law, the Minister of Finance, in consultation with the Governor of the Bank of Israel and upon the approval of the Finance Committee of the Knesset, issued an order fixing the following maximum rates of interest: 11 per cent on ordinary loans, 10 per cent on loans for agricultural and industrial purposes; and 6.5 per cent on loans linked to the consumers' price index or to the exchange rate of the Israel pound.

The new order led to a decline in the rate of interest charged by some banking institutions. On the other hand, the bigger banks raised their rate of interest somewhat, as, prior to the promulgation of this law, it did not exceed 9 per cent in practice.

The new interest rates did not contribute to a reduction in the excessive demand for credit. In 1957, as well, the Bank of Israel did not find it possible to

attempt a reduction of excessive demand for credit through an adequate adjustment of the rediscount rate and of other interest rates prevalent in the economy.

#### 4. CONCLUSIONS

In conclusion it may be said that the inflationary tendencies which accompanied the intensified economic activity in 1957 were the result of two factors:

(i) The Government deficit, financed through the expansion of bank credit, which in the first months of 1957 was the result of debt repayments for defence expenditure. In the last months of the year, the expansion was caused by an increase in public residential building construction.

The recurrent deficits are due to the fact that the expected revenue of the Government is barely adequate to cover the expenditure approved in advance. In practice, there are no reserves for wholly or partly unforeseen expenditure. Insofar as such expenditure is incurred, revenue does not rise correspondingly. Furthermore, other expenditure is not reduced accordingly, and this entails the need to rely on credit from the banking system.

(ii) The greater expansion of credit to the public. This expansion should be viewed in the light of excess demand for credit, characteristic of the Israel economy. The reasons responsible for this have been outlined in the report for 1956.

The intensified economic activity in 1957 led to strong pressure for credit by industry and agriculture. In spite of the fact that the Government deficit and the increase in foreign exchange balances at the beginning of the year greatly influenced the expansion of the money supply, the Bank of Israel was not able to offset this expansion—or at least prevent an increase—by a reduction in credit to the public. The reason for this were the strong demands for the expansion of credit voiced by agriculture and industry with which the Bank of Israel, to a certain extent, had to comply.

The expected influence of the inflationary developments on the domestic price level was partly curbed through an increase in foreign exchange outlays, both by the Government and by the other sectors. At the end of the period under review, this decelerated the rate of increase in the money supply. It did, however, impede a possible improvement in the balance of payments as well as an increase in foreign exchange reserves.