CHAPTER XVI

FLOW OF FUNDS[1]

1. Conceptual Framework

Flow-of-funds analysis is one method of describing economic activity in a country and the mutual relationships between the different sectors. For purposes of the analysis, the economy is divided into several sectors, which in turn may be classified into three broad groups:

(a) Domestic sectors mainly active in the real (i.e. nonfinancial) sphere: households and nonfinancial business firms,[2] the public sector (the Government, National Institutions, and local authorities), public sector companies,[3] and nonprofit institutions.

(b) Domestic sectors active in the financial sphere: the banking system (the Bank of Israel and banking institutions), social insurance funds, insurance companies, and financial institutions such as mortgage banks and investment companies.

(c) The rest-of-the-world sector.

Economic activity in a developed country is predominantly reflected in money flows between the economic units. A not insignificant proportion of this activity takes place within each of the sectors and is not reflected in the intersectorial flows: this applies particularly to the household and business sector. Examination of the magnitude and direction of these flows presupposes that the units included in a certain sector possess common characteristics which, insofar as they are of economic significance, differentiate them from units in other sectors. The behavior of households affects the level of private consumption in the economy and the volume of funds made available to the

[1] For a more detailed description of flow-of-funds analysis, see the relevant chapter in the Bank of Israel Annual Reports for the years 1959–64.

[2] Owing to the lack of reliable data, it is generally impossible to differentiate between the transactions of households and those of private business enterprises. Hence an analysis of the relationships between these two sectors is largely a matter of conjecture and estimation. Where it is impossible to separate the two, we shall call the combined sector the "private sector".

[3] Public sector companies are companies operating as autonomous legal entities (as distinct from the Post Office and Israel Railways, for example), and at least 25 percent of whose equity capital is owned by public sector authorities, which actively participate in the management. Public sector companies include Amidar, Mekorot, Israel Electric Corporation, Zim, El Al, Rassco, and others.

various financial sectors. Private business enterprises exert considerable influence upon the level of economic activity in general and on domestic investment in particular. The public sector is characterized chiefly by the manner in which it finances its operations (compulsory payments), and differs from other sectors also in respect of the motives governing its expenditure. Public sector companies are to be found primarily in infrastructural branches, and the public sector plays a predominant role in financing their investment and fixing the prices of their services. Nonprofit institutions operate in clearly defined spheres—health, education, and social welfare—and, owing to the non-profit-making character of their activities, are mainly dependent on unilateral transfers from other sectors. The financial sectors act as intermediaries in the transfer of funds between the nonfinancial sectors, differing from one another as regards the type of funds they raise and the type of credit they offer to their clients.

The intersector money flows relate to three types of transactions: purchases and sales of goods and services, unilateral transfers (e.g. taxes or grants), and credit transactions. The purchases of each sector are financed by the sale of goods and services, unilateral transfers, and borrowed receipts. A sector is defined as having a demand surplus when its sales and receipts from domestic transfers do not cover its purchases, and it must therefore resort to credit from domestic sources or to foreign financing (whether in the form of unilateral transfers or loans).[1] The magnitude of the demand surplus, and especially the changes therein, are among the indicators of the sector's influence on the level of demand in the economy.[2]

The system of accounts describing the flows of receipts and payments of each sector is customarily called a "balance of payments", and it is in fact similar to the balance of international payments of the economy: purchases resemble imports and sales resemble exports. Despite certain differences in the treatment of transfers as between the domestic and the international accounts, there is a conceptual similarity between the terms "deficit on current account" and "demand surplus". An economy with a deficit in its current account and a sector with a demand surplus must both resort to external financing, and the sum total of the domestic sectors' demand surpluses (net of the supply surpluses) equals the deficit on current account in the balance of payments.

A further indicator of a sector's influence on the level of demand may be

[1] A sector's receipts from sales and domestic transfers absorb funds from other sectors, reducing the purchasing power of the latter while correspondingly increasing its own purchasing power. Domestic nonbank credit also reduces the purchasing power of the lending sector, but not to the same extent, since the creditor retains a financial asset; i.e. there is a change in the composition of his assets but not in their total amount.

[2] It should be noted that an ex-post measurement of the demand surplus is by itself insufficient to determine whether changes in its magnitude were the cause or effect of the inflationary pressures revealed in the economy. In other words, the demand surplus of a sector may increase when its expenditure rises more than its receipts, while the demand pressure which caused the rise in prices and costs may have originated in other sectors.

found in its credit transactions, i.e. in the amount of credit it makes available to other sectors for financing their demand surpluses. A sector with a demand surplus can lend to other sectors if its foreign transfer receipts and borrowed receipts from all sources exceed its own demand surplus. It is difficult to establish a causal connection between the creation of a demand surplus and the financing thereof: it cannot be determined, on the basis of the money-flows structure, whether the availability of funds induced a certain sector to expand its demand, or whether the expansion of demand necessitated recourse to external sources of funds. (In this respect, there is a difference between the public and the private sector, the latter being more restricted in planning and making outlays before it has the means for financing them.)

The absence in Israel of data permitting the isolation of the real transactions of the private business sector from those of the household sector considerably limits the usefulness of flow-of-funds analysis, since these two sectors differ from each other in several respects affecting the level of the demand surplus. In many economies—probably including Israel—the saving of the business sector is insufficient to finance its investments, and it usually has a demand surplus. The household sector, on the other hand, often has a supply surplus, and its saving constitutes a source for financing business investments. (In a country whose foreign transactions on current account are balanced, the supply surpluses of some sectors must finance the demand surpluses of other sectors.) It may be that in Israel the household sector also had a demand surplus in recent years. If so, this was made possible by large-scale unilateral transfers from abroad, which helped to increase both consumption and household investment in dwellings.

2. Main Developments

The deficit in Israel's goods and services account decreased in 1965, and the aggregate demand surplus of the nonfinancial sectors diminished accordingly (see Table XVI–1). On the other hand, there were significant changes in the size of the demand surpluses of the individual sectors.

The demand surplus of the public sector, which declined in 1963 and 1964, increased in 1965, whereas the demand surplus of the nonprofit institutions continued its upward trend. The growing demand surplus of these two sectors can be ascribed to the accelerated expansion of their purchases on current account, the main cause of which were the big increases in wages and salaries paid during 1965 (see Table XVI–2).

On the other hand, the demand surplus of the business and household sector and that of the public sector companies contracted. This was connected with the smaller volume of investment in these sectors during the year reviewed.

The influence of the public sector on the level of domestic demand also found expression in a considerable expansion of credit extended to other nonfinancial

Table XVI-1

INDICATORS OF THE INFLUENCE OF REAL DOMESTIC SECTORS ON TOTAL DEMAND, 1963–65[a]

(IL million)

	Demand surplus	Net credit to or from domestic sectors[b]	Omissions and rounding of figures	Net credit from or to (–) financial sectors[c]	Net credit and transfers from abroad
	(1)	(2)	(3)	(4)	(5)
Private business enterprises and households					
1963	573	–79	13	–403	884
1964	931	–209	–4	–143	869
1965	741	–319	3	–382	801
Public sector					
1963	381	266	–1	248	400
1964	356	354	–1	196	515
1965	452	510	–	194	768
Public sector companies					
1963	234	–173	2	46	13
1964	297	–142	–	29	126
1965	251	–179	–1	68	5
Nonprofit institutions					
1963	134	–14	–1	–7	128
1964	158	–3	–1	5	151
1965	171	–12	–1	6	154
All real domestic sectors					
1963	1,322	–	13	–116	1,425
1964	1,742	–	–6	87	1,661
1965	1,615	–	1	–114	1,728

[a] Demand surplus (1) plus credit granted to other real domestic sectors (2) is conceptually equal to credit and transfers from abroad (5) plus credit from financial sectors (4). Discrepancies in totals are due to the rounding of figures and to omissions.

[b] Credit given by the sector to other real domestic sectors, less the credit received from them. (A minus sign indicates that the sector was a net recipient of credit).

[c] Credit received from the financial sectors (including the banking system), less credit given to them (including the increase in bank deposits). For the nature of the credit to the banking system, see explanation in the text.

sectors. This was due to both a certain growth in the gross credit outflow and a sharp reduction in the credit inflow from the real sectors, especially households. (A striking instance of the latter development was the decrease in the outstanding balance of the Short-Term Loan.) In order to finance the increase in its demand surplus and in its credit outflow to other real sectors, the public sector had to borrow a much larger sum from abroad. There was also a slight rise in its unilateral foreign receipts, but the amount of credit received from the financial sectors remained unchanged.

In this context, it should be noted that the other real sectors also received less credit from the financial sectors in 1965; this applies in particular to the amount lent by the banking system to the private business sector. On the other hand, the net credit flow from the public to the private sector increased in 1965. In tracing changes in the demand level, it is the net credit flow that counts. New credit granted to households and private business from public sector funds was smaller than in 1964, but at the same time the credit they granted to the public sector decreased even more. After offsetting the gross credit flows against each other, it emerges that the net amount of credit channelled by the public sector to households was almost doubled in 1965, and even the amount given to business firms was somewhat larger than in 1964.

The resumption of the upward trend in foreign currency accumulation by the banking system in 1965 was reflected by an appreciable rise in the amount which it lent to the rest-of-the-world sector. In addition, there was a conspicuous decline, as already pointed out, in the volume of net credit extended by all financial sectors—including social insurance funds and financial institutions—to the real domestic sectors during the year reviewed.

3. Demand Surpluses of the Sectors

Table XVI–2 shows the demand surpluses of the various sectors during the years 1963–65. As already mentioned, the principal real sectors displayed a change in trend in 1965, as compared with 1964.

The big increase in the demand surplus of the household and business sector in 1964 was ascribed primarily to the considerable expansion of business investment, and also to the marked rise in household purchases of dwellings and durable consumer goods. In 1965 the demand surplus of the private sector contracted, following decreases in these same component items.

Private consumption grew at the same rate as in 1964—about 16 percent at current prices. However, the real increase was smaller in 1965, owing to the much more rapid rise in the price level. On the other hand, the year reviewed witnessed a slight decline in most investment items, in sharp contrast to the growth of some 25 percent registered in 1964.

In general, there is a connection between changes in invesment and changes in the size of the demand surplus. When the volume of investments financed

Table XVI–2

DEMAND OR SUPPLY SURPLUSES, BY SECTOR, 1963–65[a]

(IL million)

Sector	Purchases on current account	Purchases on capital account	Sales	Net purchases (1)+(2) −(3)	Transfers to domestic sectors	Transfers from domestic sectors	Net transfers (5)−(6)	Demand or supply (−) surplus (4)−(7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Private business enterprises and households[b]								
1963	4,797	1,405	—	—	—	—	—	573
1964	5,542	1,766	—	—	—	—	—	931
1965	6,445	1,713	—	—	—	—	—	741
Public sector[c]								
1963	1,829	422	182	2,069	575	2,263	1,688	381
1964	2,090	547	231	2,406	687	2,737	2,050	356
1965	2,458	614	256	2,816	816	3,180	2,364	452
Public sector companies[d]								
1963	724	384	872	236	16	18	2	234
1964	779	456	928	307	20	30	10	297
1965	886	391	1,017	260	20	29	9	251
Nonprofit institutions[e]								
1963	485	77	104	458	18	342	324	134
1964	559	112	129	542	23	407	384	158
1965	650	115	150	615	31	475	444	171
Social insurance funds and insurance companies[f]								
1963	113	10	138	−15	118	120	2	−17
1964	146	10	177	−21	153	154	1	−22
1965	184	8	200	−8	165	192	27	−35

[a] Figures for 1963 and 1964 have been revised.
[b] Calculated residually by deducting the demand surpluses of other sectors from the supply surpluses.
[c] As defined in Chapter VII, "Public Sector Operations", except that sales include interest received.
[d] Companies in which the public sector holds at least 25 percent of the equity capital and actively participates in the management.
[e] As defined in Chapter VIII, "Nonprofit Institutions".
[f] As defined in Chapter XVIII, "Social Insurance Funds and Insurance Companies".

Table XVI–2

DEMAND OR SUPPLY SURPLUSES, BY SECTOR, 1963–65[a] (contd.

(IL million)

Sector	Purchases on current account	Purchases on capital account	Sales	Net purchases (1)+(2) −(3)	Transfers to domestic sectors	Transfers from domestic sectors	Net transfers (5)−(6)	Demand or supply (−) surplus (4)−(7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Banking system[g]								
1963	227	11	304	−66	45	—	−45	−21
1964	271	27	349	−51	47	—	−47	−4
1965	340	16	415	−59	53	—	−53	−6
Financial institutions[h]								
1963	84	4	111	−23	18	—	−18	−5
1964	139	7	174	−28	22	—	−22	−6
1965	181	6	234	−47	37	—	−37	−10
Rest of the world[i]								
1963	1,795		3,074	−1,279	—	—	—	−1,279
1964	1,858		3,566	−1,708	—	—	—	−1,708
1965	2,134		3,698	−1,564	—	—	—	−1,564

[g] Commercial banks, cooperative credit societies, and the Bank of Israel.
[h] As defined in Chapter XVII, "Financial Institutions".
[i] Sales include imports as per the balance of payments, and purchases include exports.

from internal sources, such as depreciation or retained earnings, remains unchanged, it may be assumed that an expansion of investment will increase the demand surplus approximately to the same extent, while the opposite is true when capital outlay contracts.[1]

Table XVI–3 shows that the demand surplus of the private sector did in fact change in the same direction as its investment (it increased in 1964 and decreased in 1965), but not to the same extent. In other words, there was a change in the proportion of investment financed from internal sources. This fact is reflected by the rise in the ratio between the demand surplus and purchases on capital account in 1964, and a fall in this ratio in 1965.

It is difficult to ascertain from the available data what exactly caused the marked rise in the weight of the private sector's demand surplus in 1964.

[1] The growth of the economy's capital stock is accompanied by an increase in the amount allocated for depreciation, thus making it possible to finance a larger volume of investment from internal sources. Assuming a constant rate of saving, the demand surplus may be expected to increase a little more slowly than investment.

Possibly, a big expansion of investment, such as occurred in 1964, necessitates greater recourse to external sources of funds (the increase in investment in 1964 was very nearly equal to the increase in the demand surplus, whereas in 1965 the decline in the demand surplus exceeded the decrease in investment).[1] Two tentative explanations may be advanced about developments in 1965 as compared with 1964:

(a) The invesment item showing the most pronounced change was inventories. Investment in inventories expanded considerably in 1964, but hardly at all in 1965. It may be that a larger proportion of this type of investment is financed by credit than is the case with other types of investment.

(b) Purchases of durable goods, a large part of which is financed by credit, expanded in 1964 by over 20 percent, while in 1965 the increase came to only 5 percent.

The reasons for the contraction of investment by private business are not revealed by the data available. The uncertainty concerning future economic prospects may have been a contributory factor, while other possible causes may have been a compensating drop in the exceptionally high level attained in the previous year, and the expectation of a decline in profitability. Moreover, the size of one component of business investment is unknown, and sharp fluctuations therein may alter the picture presented by Table XVI–3. The reference is to the stock of dwellings held by private builders. If it increased appreciably in 1965, the investment of households in dwellings was smaller than shown in the table, while business investment was correspondingly larger.

The demand surplus of the public sector rose considerably, after declining during the two preceding years. In 1964 transfers of other domestic sectors to the public sector increased appreciably more than total net purchases of the latter—by 21 percent as against 16 percent, with purchases on current account going up by only 14 percent. In 1965, on the other hand, an opposite trend manifested itself: the absorption from other domestic sectors increased to a smaller extent than net purchases (16 as against 17 percent), with the growth of purchases on current account being even larger (18 percent).

A detailed analysis of developments in the public sector is given in Chapter VII, "Public Sector Operations". Here we shall only mention the main cause of this sector's bigger demand surplus: an extraordinarily big increase in current expenditure, especially wages and salaries, simultaneously with the slower expansion of tax revenue. The lag of tax revenue behind the growth of expenditure was

[1] The conclusions concerning 1965 must be treated with reserve. The demand surplus of the private sector has been calculated as a residual (i.e. by deducting the demand surpluses of the other real sectors from the supply surpluses of the rest-of-the-world and the financial sectors). Should a change occur in the estimate of the rest-of-the-world sector's supply surplus—a strong possibiility in view of the size of the "errors and omissions" item in the 1965 balance of payments—there would be a corresponding change in the estimate of the private sector's demand surplus.

Table XVI-3

CONSUMPTION, INVESTMENT, AND DEMAND SURPLUS OF HOUSEHOLDS AND BUSINESS ENTERPRISES, 1963-65[a]

(IL million)

	1963	1964	1965
Purchases by households			
Consumption[b]	4,797	5,542	6,445
Investment in housing[c]	587	722	776
Investment of business enterprises[d]	818	1,044	937
Total purchases by households and investment of business enterprises	6,202	7,308	8,158
Demand surplus of the private sector	573	931	741
Demand surplus as a percentage of total purchases	9.2	12.7	9.1
Demand surplus as a percentage of purchases on capital account	40.8	52.7	43.3

[a] Data for 1963 and 1964 have been revised.
[b] Private consumption less consumption of nonprofit institutions.
[c] Total public and private expenditure on housing, less the increase in the dwelling stock of Amidar Ltd., but unadjusted for changes in the dwelling stock of other builders.
[d] Total gross invesment in the economy less capital expenditure of the other sectors (excluding that of Amidar).

particularly striking in the case of the local authorities, where the demand surplus rose considerably. This is a good example supporting the theory advanced above, that in the public more than in the private sector the level of expenditure determines the amount of financing required rather than it being determined by the availability of such financing.

The slower expansion of expenditure on capital account was connected with the completion of a number of big investment projects, such as the National Water Carrier, but it may also have been due to the fact that capital outlays had to be trimmed because of the rapid rise in the public sector's current expenditure. It should be stressed, however, that the public sector did not reduce the amount of credit which it made available to other sectors for financing investments.

The size of the demand surplus of public sector companies is closely related to the volume of their investment. After a big increase in investment—and the demand surplus—in 1964, both contracted during the year reviewed. It should be noted that the decline in the demand surplus relative to that in investment was smaller than the increase in the demand surplus relative to investment in 1964. This reflects a certain growth in the companies' dependence on external sources for financing their investments. The companies showed different rates of change in their capital outlay: in 1965 there was a sharp drop in that of Zim Israel Navigation Co. Ltd. (which had been particularly large in

1964), as well as in that of the Dead Sea Works and of Chemicals and Phosphates Ltd. On the other hand, the figure for the Israel Electric Corporation was appreciably higher, while in construction and petroleum it remained at approximately the 1964 level.

The data show that sales by public sector companies have been expanding rather slowly in recent years. This stands out all the more when viewed against the background of their large-scale investments during this period. A partial explanation may be found in the nature of some of the companies' activities: for instance, Amidar, one of the leading investors in the sector, obtains most of its revenue from rent, an item which increases but slowly. Many of the concerns did not revise their prices in line with the rise in the general level—either because most of their output was earmarked for export, or because of Government controls. In addition, some of the sector's investments presumably had not yet fully matured.

The nonprofit institutions have a "structural" demand surplus, arising from the fact that some of them depend on unilateral transfers from abroad for covering their current expenditure. A number of big institutions finance a considerable part of their investment budgets from this source. However, this sector does not display a high correlation between changes in investment and changes in the demand surplus. As in the case of the public sector, current expenditure in 1965 increased relatively fast as compared with the preceding year, while the volume of investment remained virtually unchanged. The cause of this development was the same in both sectors—salary scales in the health institutions and institutes of higher learning are linked to those of public sector employees, so that expenditure on wages and salaries rose steeply during the year reviewed.

4. Financing the Demand Surpluses

The sources for financing the demand surpluses of the nonfinancial domestic sectors are summarized in Table XVI–4. As already mentioned, there are three such sources:

(a) Unilateral receipts from abroad.

(b) Credit from abroad.

(c) Credit from domestic sectors.

Unilateral receipts from abroad have been declining since 1963, but at a slow rate. The weight of these transfers relative to the aggregate demand surplus of all real domestic sectors still came to about two-thirds in 1965, as compared with nearly four-fifths in 1963. Over half the unilateral transfers in 1965 went to households, while of the remainder, two-thirds went to the public sector and one-third to nonprofit institutions. Unilateral receipts differ from the other sources of financing demand surpluses in that they do not create liabilities which will have to be paid in the future out of the available resources.

Since 1964 unilateral transfers have not been covering the demand surplus of the public sector. In order to finance its demand surplus and grant credit on a large scale (chiefly through the development budget), the sector has required credit from both domestic and foreign sources. It can be argued that in the long run it would be preferable if the credit outflow were based on a supply surplus. The growth of the external debt burden will make it impossible to rely much longer on net borrowing from abroad as a source of funds. On the other hand, a big expansion of credit from other domestic sectors will prevent all but the public sector from raising funds in the local capital market, the scope of which is quite limited. Meanwhile, the public sector is continuing to increase its foreign borrowing at a rapid rate, the figure moving up from IL 147 million (net) in 1963 to IL 482 million (net) in 1965. Net credit from other domestic sectors, on the other hand, declined somewhat as compared with 1963, though the public sector's predominance in the local capital market was not diminished, as is explained below.

Public sector companies depend mainly on credit from the public sector for financing their demand surplus. Some companies also receive credit from abroad—for instance, the World Bank loan granted to Dead Sea Works Ltd., or credit from foreign shipyards to Israeli companies for the purchase of ships (this source was responsible for the big increase in foreign credit to public sector companies in 1964). In 1965 the volume of foreign credit contracted sharply, this decline being partly offset by additional credit from domestic sources, particularly the public sector.

The demand surplus of nonprofit institutions is covered almost entirely by unilateral transfers from abroad. It should be noted that while these institutions' domestic borrowed receipts expanded appreciably in 1965, their importance as a source of funds is still limited, owing to the noncommercial nature of the nonprofit institutions. The institutions' financing difficulties are reflected not so much by a demand for more credit as by pressure for larger transfers from the public sector. In recent years the relative share of the public sector in domestic transfers to nonprofit institutions has been rising, but this development is not reflected in the size of their demand surplus or in the methods of financing it.

The demand surplus of the private sector is greater than that of any other sector in the economy, but it is difficult to generalize about the sources financing it. Transfers from abroad go only to households, and in fact only to a small percentage of them. These households constitute an important source of credit for the banking system, mainly by way of Pazak and Tamam deposits.However, because of the liquidity regulations applying to these deposits, the banking institutions cannot utilize them for extending additional credit to the economy. A large percentage of the households make credit available to other sectors through their saving in social insurance funds and insurance companies. Credit

Table XVI–4

FINANCING OF DEMAND SURPLUSES, BY SECTOR, 1963–65[a]

(IL million)

Sector	Transfers from the rest of the world	Net credit from the rest of the world	Net credit from domestic sectors[b]	Net credit to domestic sectors[c]	Total net credit received or granted (–) (2)+(3)–(4)	Ajustments and rounding-off	Demand or supply (–) surplus (1)+(5)+(6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Private business enterprises and households							
1963	682	202	241	536	–93	–16	573
1964	636	233	585	519	299	–4	931
1965	582	219	539	602	156	3	741
Public sector							
1963	253	147	248	266	129	–1	381
1964	217	298	196	354	140	–1	356
1965	286	482	194	510	166	—	452
Public sector companies							
1963	—	13	238	19	232	2	234
1964	—	126	196	25	297	—	297
1965	—	5	258	11	252	–1	251
Nonprofit institutions							
1963	128	—	15	8	7	–1	134
1964	151	—	13	5	8	–1	158
1965	154	—	22	4	18	–1	171
Social insurance funds and insurance companies							
1963	—	8	206	233	–19	2	–17
1964	—	–2	234	250	–18	–4	–22
1965	—	—	251	286	–35	—	–35
Banking system							
1963	—	–215	346	150	–19	–2	–21
1964	—	–9	284	278	–3	–1	–4
1965	—	–225	375	159	–9	3	–6
Financial institutions							
1963	—	77	55	137	–5	—	–5
1964	—	71	121	198	–6	—	–6
1965	—	63	121	188	–4	–6	–10
Rest of the world[d]							
1963	–1,063	—	249	481	–232	16	–1,279
1964	–1,004	—	32	749	–717	13	–1,708
1965	–1,022	—	249	793	–544	2	–1,564

[a] Data for 1963 and 1964 have been revised.
[b] Total of the columns in Table XVI–6, less credit from the rest of the world.
[c] Total of the rows in Table XVI–6, less credit to the rest of the world.
[d] The data cited here differ slightly from those in Chapter III, "The Balance of Payments", owing to conceptual differences.

to business enterprises by way of the bill brokerage trade is likewise supplied mainly by households. On the other hand, households are large recipients of credit, primarily for housing purposes. There is also a certain flow of credit from business enterprises to households in the form of consumer credit, but no data are available on its dimensions.[1] Despite the fact that data are not available on some components of the households' credit inflow and outflow, there is no doubt that the household sector as a whole gives more credit than it receives, and that its demand surplus is covered by unilateral transfers from abroad, which—despite a certain decrease—still exceeded IL 580 million in 1965.

The demand surplus of the business sector is wholly financed by credit—partly from abroad (direct investments, purchases of securities, and loans), but to a greater extent from internal sources (the financial, public, and household sectors). The known component of household credit to business enterprises in the last few years is bank-negotiated bill credits, but there have undoubtedly been other forms of credit as well. On the other hand, consumer credit has been granted by business to households. The financing of the demand surplus of the private sector as a whole underwent a slight change in 1965: transfers and foreign borrowing exceeded the demand surplus during the year reviewed, so that the sector did not require credit from other domestic sectors, in contrast to the situation in 1964.

5. The Financial Sectors in the Money-Flows System

The financial sectors occupy a special position in the money-flows system in that most of their incoming and outgoing funds are not connected with sales and purchases of goods and services. Since demand and supply surpluses originate in income-producing activities, the financial sectors do not have big surpluses of either kind.

The financial sectors help the real sectors to finance their demand surpluses. Their operations are hardly reflected in Tables XVI–2 and XVI–4, since the most significant aspect of their operations is not their total credit inflow and outflow (which are perforce of fairly similar magnitudes), but the sectorial composition of the two.

Before summarizing the intersectorial credit flows, we shall briefly describe the characteristics distinguishing the financial sectors from the standpoint of the sources and uses of their funds.

[1] The outstanding balance of consumer credit is undoubtedly large, but the changes therein from year to year are probably small. Most consumer credit is short-term. In the absence of reliable data, it is unwise to draw conclusions.

(a) *The banking system*

This sector possesses two characteristics differentiating it from the other financial sectors. The first is connected with the fact that a large percentage of its liabilities constitute means of payment. In contrast to other financial sectors, which can give credit only if they have succeeded in raising funds, the banking system is not subject to this limitation. By giving credit it creates means of payment, which in the system of money flows are classified under sources of funds, though they are inherently different from those of the other financial sectors.

However, the banking institutions do not have a free hand in granting credit; they are subject to regulation by the central bank, which forms part of the banking system. Under the existing liquidity regulations, the banks may not lend at all from Pazak and Tamam deposits, which must be redeposited in full with the Bank of Israel. The foreign currency accumulated in connection with these deposits is reflected in the grant of credit to the rest of the world by the banking system (in the form of deposits with foreign banks).

Part of the banking institutions' credit transactions in recent years are not reflected in the money flows, as here presented. The bill brokerage trade formally constitutes credit from households to business enterprises, and the banks' mediation in such transactions is not reflected in the money flows. This presentation, though formally correct, suffers from the drawback of ignoring the key role of the banking institutions in the raising and allocation of the funds. In general, we ignore the intermediary in the money-flows system only when the decision concerning the allocation of funds is in the hands of the originating sector. Thus, for example, loans from Government deposits with banking or financial institutions are regarded as credit granted by the Government to the borrowing sectors, since the Government decides its allocation.

(b) *Social insurance funds and insurance companies*

These are the principal savings institutions in Israel. They raise the bulk of their funds from households, but do not act as independent financial intermediaries when it comes to the allocation of these funds, as most of their investments are subject to Government control. The Government's predominance in the bond market largely stems from its channelling of monies accumulated in social insurance funds and insurance companies—in roughly equal measure to the private sector, public sector companies, and the Government itself on the one hand, and to the financial sectors on the other (the financial institutions and the banking system receive considerable credit from this source).

(c) *The financial institutions*

In Israel these institutions obtain only a small part of their funds from households, the main source being social insurance funds, the banking system, and the rest-of-the-world sector. Much of the financial institutions' activity is not reflected in the money-flows system, since the credit granted from Government deposits is regarded as Government credit.

6. Credit Flows

The financial sectors receive and give credit in approximately equal amounts, since they act as intermediaries between the various nonfinancial sectors (including the rest of the world). Among the domestic real sectors, only one grants more credit than it receives—the household sector. The rest-of-the-world sector also extends far more credit to the domestic sectors than it receives from them.

The other nonfinancial sectors—the public sector, public sector companies, and especially private business enterprises—are characteristically recipients of credit, though the public sector is also a large lender.

When examining the credit relationships between the various economic sectors, it is important to differentiate between the information presented in Table XVI–5 and that in Table XVI–6. The intersector credit flows are in many cases bilateral. Thus the public sector borrows from households through the sale of debentures, and also lends them money to buy homes. Social insurance funds receive credit from business enterprises in the form of severance pay insurance premiums, and grant them credit as part of their approved investments. The same applies in other cases. The magnitude of each of the gross credit flows is of interest, but in order to clarify the mutual credit relationships between the sectors, it is necessary to offset the credit outflow against the credit inflow between each pair of sectors. It should be noted that credit includes not only loans granted but also repayments of loans received in the past, this too being clearly reflected in the net credit-flows structure.

Following are the main developments in the credit flows of the various sectors in 1965.

(a) *Households*

Households provided more credit to the financial sectors than in 1964. Credit to social insurance funds and insurance companies constitutes long-term saving, which is channelled to all branches of the economy. On the other hand, credit to the banking system is of a quite different nature, much of it forming part of the money supply (cash and demand deposits), while another large part consists of Pazak and Tamam deposits, which are also fairly liquid assets. (It should be noted, however, that the reduced scale of foreign currency conversion, reflected by the big increase in Pazak and Tamam deposits, eased demand pressure in the economy in 1965.) Households also provide credit to financial institutions—both by purchasing securities and by buying contractors' deposits—thereby facilitating the financing of mortgage loans.[1] In 1964 households were lenders to the public sector as well, but the decline in the outstanding balance of the Government Short-Term Loan in 1965 meant that there was a reversal of the direction of the credit flow. The net outcome was that, while the volume of new loans granted by the public sector to households in 1965 was smaller than in the previous year, net credit to the household sector was nearly double that of 1964.

Household loans to private business in the form of bank-negotiated bill credits contracted slightly as compared with 1964. It is also possible that the volume of credit granted by business to households decreased (no data on this point are available), following the slower rise in purchases of durable consumer goods, which is the main type of transaction financed by consumer credit.

The amount borrowed by households from financial institutions and social insurance funds changed only very slightly in 1965.

(b) *Business enterprises*

Together with the slower growth of business investment, the demand surplus of this sector presumably declined. Supporting this assumption is the fact that aggregate new credit received by private business was approximately IL 150 million smaller than in 1964. Credit from the banking system to business enterprises fell off conspicuously, and there was no compensating change in the volume of credit received from other sectors. It is difficult to ascertain what was the cause and what the effect of the decline in credit and investment, but the slower expansion of investment may possibly have been due to difficulties in obtaining financing on the previous year's scale.

The sources of funds for private business enterprises in 1965 were, in order of magnitude: the rest-of-the-world sector, households, the public sector, and financial institutions. In the main, the same structure of financing was evident in 1964, except that the amount received from the banking system was similar that year to that obtained from the financial institutions and the public sector.

(c) *Public sector*

This sector, and especially the Government, holds a key position in the credit-flows structure, even greater than is revealed by the figures. The public sector was a large recipient of credit in 1965—mainly from abroad, but also from the banking system and other financial sectors. Compared with 1964, two developments stand out in particular: (1) the amount received from abroad increased appreciably; and (2) households did not lend to the public sector at all—the redemption of securities purchased by households in previous years exceeded new issue proceeds.

Credit from the public sector went chiefly to public sector companies, house-

[1] See Chapter XVII, "Financial Institutions", section 5(d).

holds, and private business enterprises. There was an increase in new lending only to public sector companies, but if repayments are taken into account, it emerges that net credit given to these three sectors together was larger in 1965 than in 1964, and that the biggest increase was in net credit to households.

The public sector, as stated, received credit from social insurance funds, insurance companies, and financial institutions, but the Government influences the flow of funds here not only by its borrowings. The regulations concerning "approved investments" determine the allocation of credit from the social insurance funds, while the financial institutions are dependent on the public sector for authorization of new security issues in Israel and abroad. The Government makes its authorization of the new issues and their sale to these funds conditional on the financial institutions agreeing to allocate their credit in conformity with its directives.

(d) *Public sector companies*

In 1965 the public sector companies received a much larger amount from the public sector, but much less from abroad (the exceptionally big increase in foreign receipts in 1964 was connected with the purchase of ships that year). There were no striking changes in credit from the financial sectors, though there was some increase in receipts from the banking system.

Public sector companies give virtually no credit to other sectors. What they do give consists mainly of supplier credit to business concerns and repayments on loans received in the past.

(e) *The rest-of-the-world sector*

This sector extends credit on a considerable scale to several domestic sectors, notably the public sector and private business enterprises. In 1965 it provided a larger amount to the public sector, whereas that to private business remained at approximately the 1964 level. The financial institutions also borrow abroad, but on a relatively small scale as compared with the two sectors mentioned above.

Two domestic sectors lend to the rest of the world. The accumulation of foreign exchange reserves by the banking system, which was considerably accelerated in 1965, appears in the flow-of-funds system as credit to the rest-of-the-world sector. Purchases of foreign securities (the scope of which is small) constitute another form of credit to this sector.

(f) *The banking system*

We have already mentioned the special character of the credit received by this sector (means of payment on the one hand, and Pazak and Tamam deposits

Table XVI-5

GROSS INTERSECTORIAL CREDIT FLOWS, 1964[a]–65

(IL million)

Receiving sector / Lending sector	Public sector	Public sector companies	Nonprofit institutions	Business enterprises	Households	Total credit to sectors with a demand surplus	Rest of the world	Banking system	Social insurance funds and insurance companies	Financial institutions	Total credit granted
Public sector											
1964	×	158	8	92	184	442	315	–85	—	16	688
1965	×	233	15	82	168	498	306	–96	—	21	729
Public sector companies											
1964	19	×	—	75	8	102	38	–3	—	35	172
1965	63	×	—	64	7	134	64	1	1	24	224
Nonprofit institutions											
1964	6	—	×	1	6	13	—	5	—	1	19
1965	2	—	×	—	4	6	—	6	—	—	12
Business enterprises											
1964	–15	57	6	×	[b]	48	94	64	25	55	286
1965	–38	53	2	×	[b]	17	108	81	37	21	264

Households											
1964	78	29	2	179[c]	—	288	21	262	268	44	883
1965	–39	27	1	161[c]	—	150	24	331	291	58	854
Rest of the world											
1964	613	164	—	348	[b]	1,125	×	116	1	68	1,310
1965	788	69	—	351	[b]	1,208	×	112	—	63	1,383
Banking system											
1964	16	–8	8	191	3	210	125	×	—	24	359
1965	2	13	8	96	2	121	337	×	—	51	509
Social insurance funds and insurance companies											
1964	73	36	3	72	34	218	3	20	×	72	313
1965	65	43	5	77	40	230	—	46	×	89	365
Financial institutions											
1964	38	33	—	170	105	346	–3	–23	1	×	321
1965	52	38	–1	127	95	311	—	19	1	×	331
Total credit received											
1864	828	469	27	1,128	340	2,792	593	356	295	315	4,351
1965	895	476	30	958	316	2,675	839	500	330	327	4,671

[a] Revised figures.
[b] No data are available on credit flows between these sectors.
[c] Represents only part of the credit granted—namely, the change in the balance of the bill brokerage trade. We have assumed that most of the money in this market originated in households. No data are available on loans from households to business enterprises and their other investments therein.

Table XVI–6

NET INTERSECTORIAL CREDIT FLOWS, 1964[a]–65

(IL million)

Receiving sector / Lending sector	Public sector	Public sector companies	Nonprofit institutions	Business enterprises	Households	Total credit to sectors with a demand surplus	Rest of the world	Banking system	Social insurance funds and insurance companies	Financial institutions	Total credit granted
Public sector											
1964	×	139	2	107	106	354	—	—	—	—	354
1965	×	170	13	120	207	510	—	—	—	—	510
Public sector companies											
1964	—	×	—	18	—	18	—	5	—	2	25
1965	—	×	—	11	—	11	—	—	—	—	11
Nonprofit institutions											
1964	—	—	×	—	4	4	—	—	—	1	5
1965	—	—	×	—	3	3	—	—	—	1	4
Business enterprises											
1964	—	—	5	×	[b]	5	—	—	—	—	5
1965	—	—	2	×	[b]	2	—	—	—	—	2

1964	—	21	—	179[c]	×	200	21	259	234	—	714
1965	—	20	—	161[c]	×	181	24	329	251	—	785
Rest of the world											
1954	298	126	—	254	[b]	678	×	—	—	71	749
1965	482	5	—	243	[b]	730	×	—	—	63	793
Banking system											
1964	101	—	3	127	—	231	9	×	—	47	287
1965	98	12	2	15	—	127	225	×	—	32	384
Social insurance funds and insurance companies											
1964	73	36	3	47	—	159	2	20	×	71	252
1965	65	42	5	40	—	152	—	46	×	88	286
Financial institutions											
1964	22	—	—	115	61	198	—	—	—	×	198
1965	31	14	—	106	37	188	—	—	—	×	188
Total credit received											
1964	494	322	13	847	171	1,847	32	284	234	192	2,589
1965	676	263	22	696	247	1,904	249	375	251	184	2,963

[a] Revised figures.
[b] No data are available on credit flows between these sectors.
[c] Partial data (see note [c] to Table XVI–5).

on the other). It is worth noting that banking institutions also received credit from abroad, in the form of foreign residents' deposits and loans from foreign banks, but the credit granted abroad in the form of foreign currency accumulation (chiefly with the Bank of Israel) was even greater.

Credit from the banking system to private business contracted sharply in 1965, while credit to the public sector was on approximately the previous year's level. It should be noted, however, that the banking system also makes credit available to private business through the bill brokerage trade, even though such credit is directly attributed to households, as explained above.

(g) *Social insurance funds and insurance companies*

The credit received by this sector originates almost entirely from households, in the form of contributions to provident and pension funds and premium payments to life insurance companies. Credit from private business represents the accumulation of severance pay funds in a number of special funds operated by insurance companies and banks.

Credit by social insurance funds is for the most part controlled by the public sector. Relatively large amounts are channelled to financial institutions and to the public sector itself, but credit to business enterprises, the banking system, and public sector companies is also quite substantial (most of the accumulation in the life insurance fund is used by the insurance companies to purchase linked debentures of the Israel Electric Corporation). The most notable change in the allocation of credit by social insurance funds and insurance companies in 1965 was the increase in the amount supplied to the banking system.[1]

(h) *The financial institutions*

The social insurance funds and the rest of the world remain the most important sources of credit for the financial institutions. During the last two years these institutions also received credit from the banking system, mainly as interim financing on account of loans due to be received from abroad.

The big sums made available to the financial institutions by the public sector in the form of deposits earmarked for loans are treated, as already pointed out, as credit granted directly by the Government to the final borrowers.

In 1965 financial institutions raised funds from households by selling deposits of contractors and building companies earmarked for the granting of mortgage loans to home buyers.

The main recipients of financial institution credit are private business firms and households. In 1965 the amount made available to these two sectors by the

[1] Under an agreement with the Treasury, approximately half the accumulation in social insurance funds is channelled to institutions belonging to the Histadrut (General Federation of Labor), part of it through the banking system.

financial institutions contracted somewhat. On the other hand, there was a slight increase in credit granted to the public sector and to public sector companies.

In conclusion, it may be said that the most striking characteristics of the credit-flows system described above are that a considerable part of the credit granted to domestic sectors originates abroad, and that the public sector occupies a key position both as regards the direct mobilization and lending of funds and as regards the allocation and control of funds raised by the financial sectors.