

## CHAPTER XVI

# FLOW OF FUNDS

### 1. CONCEPTUAL FRAMEWORK<sup>1</sup>

THE FLOW-OF-FUNDS system is a statistical framework which describes the financial transactions accompanying the economic activity of a country; it provides a means of studying the influence of the various sectors on such activity and their mutual financial relationships.

The flow-of-funds system differs from the conventional system of national accounts in two important respects: first, the former includes the financial transactions (the receipt and grant of various types of credit) of the domestic sectors, which are excluded from the national accounts. Second, the economic units in the flow-of-funds system are classified according to the characteristics which determine their behavioral pattern, i.e. by field of economic activity and ownership, while the sectorial classification in the national accounts system is mainly according to the economic function of the units, i.e. production, consumption, investment, etc.

The flow-of-funds structure comprises nine sectors, which may be subdivided into three broad groups:

(a) Real (i.e. nonfinancial) domestic sectors. These are domestic sectors mainly active in the production or consumption of goods and services. The group includes households, nonfinancial business firms,<sup>2</sup> the public sector (the Government, National Institutions, and local authorities), public sector companies,<sup>3</sup> and nonprofit institutions.

(b) Financial domestic sectors: the banking system (banking institutions and the Bank of Israel), financial institutions (mainly mortgage and develop-

<sup>1</sup> 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.

<sup>2</sup> 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".

<sup>3</sup> 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.

ment banks and investment companies), social insurance funds, and insurance companies.

(c) The rest-of-the-world sector: all economic units outside the Israeli economy.

The flow-of-funds system describes two types of intersectorial transactions:

(a) Real transactions: purchases and sales of goods and services (on current and capital account), transfer payments (mainly taxes and grants), and transfer receipts.

In flow-of-funds analysis a sector is defined as having a demand surplus if its income from sales and domestic transfer receipts fails to cover its expenditure on current and capital account plus domestic transfer payments, and it must therefore resort to credit from domestic sources or to foreign financing (transfer receipts and credit). The changes in the demand surplus of a sector are, as will be shown below, an indication of the sector's influence on the level of demand in the economy.

(b) Financial transactions: the granting and receipt of credit through all the financial instruments in the capital market.

Data on the flow of funds are obtained from the receipt and payment accounts of the sectors, which are customarily known as the sectorial "balance of payments". There is, in fact, a conceptual resemblance between the structure of these accounts and that of the country's balance of international payments. Purchases resemble imports and sales resemble exports, although the meaning of unilateral transfers is not strictly analogous. A similarity also exists between the concepts of "deficit on current account" and "demand surplus" as defined above: an economy with a deficit on current account and a sector with a demand surplus must both resort to external financing.

Flow-of-funds analysis is based on the assumption that in a modern economy, where most economic activity is connected with the money flows between the various units, the real and financial transactions carried out by the units are interdependent, and that developments in the capital market can help in understanding developments in the real markets.

The demand surplus of a sector, and particularly the changes taking place therein, indicate the sector's influence on aggregate demand. This magnitude represents the difference between the sector's use of real resources and its contribution to the supply of real resources.<sup>1</sup>

<sup>1</sup> A sector's receipts from sales and domestic transfers absorb funds from other sectors, reducing their purchasing power while correspondingly increasing its own. 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. It should be noted that ex-post data indicate the *results* of demand pressure in the economy. An increase in the demand surplus of a sector does not necessarily mean that it originated in the sector itself: the demand surplus of a sector is likely to increase with a rise in its expenditure, while the demand pressure which pushed up prices and costs may have originated in other sectors.

Another indicator of a sector's influence on the level of demand may be 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 borrowings 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 from the money-flows structure whether the availability of funds induced a 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 to finance 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 the two differ 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 is a source for financing business investments. The household sector in Israel may also have had a demand surplus in recent years. If so, it was made possible by the large-scale unilateral transfer from abroad, which helped to increase both consumption and household investment in dwellings.

## 2. MAIN DEVELOPMENTS

The demand surplus of the private sector (businesses and households) declined in 1966 and that of the public sector increased. This trend started in 1965 and became stronger in 1966.

The contractionary effect of the decline in the private sector demand surplus was not offset by the rise in the demand surplus of the public sector, a development reflected by the failure of the national product to expand in 1966 and by a decrease in the balance of payments deficit on current account. The demand surpluses of the public sector companies and nonprofit institutions rose in 1965 and fell in 1966, thereby accentuating the effect of the reduction in the private sector demand surplus in the year reviewed (see Table XVI-1).

The changes in the demand surplus of the private sector in 1965 and 1966 must be analyzed with caution, owing to the magnitude of the "errors and omissions" item in the country's balance of payments in the two years. In the flow-of-funds system presented in this chapter, the private sector data are

Table XVI-1

INDICATORS OF THE INFLUENCE OF REAL DOMESTIC SECTORS  
ON TOTAL DEMAND, 1964-66<sup>a</sup>

(IL million)

	Demand surplus	Net credit to or from (-) domestic sectors <sup>b</sup>	Errors and omissions	Net credit from or to (-) financial sectors <sup>c</sup>	Net credit and transfers from abroad
	(1)	(2)	(3)	(4)	(5)
<b>Private business and households</b>					
1964	828	-108	-21	-143	884
1965	430	-99	-94	-445	870
1966	94	56	-232	-344	726
<b>Public sector</b>					
1964	457	253	-1	196	515
1965	668	406	—	241	833
1966	876	221	2	465	630
<b>Public sector companies</b>					
1964	297	-142	—	29	126
1965	336	-262	-5	77	2
1966	232	-250	-11	52	-59
<b>Nonprofit institutions</b>					
1964	158	-3	-1	5	151
1965	217	-45	2	14	156
1966	198	-27	-2	36	137
<b>All real domestic sectors</b>					
1964	1,740	—	-23	87	1,676
1965	1,651	—	-97	-113	1,861
1966	1,400	—	-243	209	1,434

<sup>a</sup> The figures for 1964 and 1965 have been revised. 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 omissions and rounding of figures.

<sup>b</sup> Credit given by the sector to other real domestic sectors, less the credit received from them.

<sup>c</sup> 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.

derived as a residual, so that they contain the errors and discrepancies in the figures for the other sectors.<sup>1</sup>

The decline in the private sector's demand surplus stemmed from a reduction of business investment. The latter was due to a number of factors: the smaller volume of immigration, the contraction of foreign transfers and investments in Israel, the arresting of the upward trend in profitability and even a decline in some sectors, and the accumulation of a stock of vacant dwellings by contractors.

The decline in investments was aggravated by the increasingly pessimistic outlook of investors due to the slower growth of incomes and demand as the recession wore on. In addition, the composition of household saving underwent a change, purchases of dwellings and durable goods falling and holdings of liquid financial assets rising. This decline in household demand was also connected with the uncertainty prevailing in the economy in 1966 and with the expectation of a fall in the prices of real assets. The growth of the public sector's demand surplus is attributable to the rapid rise in its expenditure in 1965 and 1966, which was not accompanied by a corresponding increase in net domestic transfer receipts.

Most of the additional public sector outlay was on current account. Purchases on capital account changed only slightly; together with the sharp decrease in private sector investment, this resulted in a smaller domestic capital formation.

Changes in the level and nature of the activity of the various sectors are reflected by a number of developments in the capital market.

Net credit from the public sector to other domestic sectors declined considerably in 1966.<sup>2</sup> In order to finance its demand surplus and extend credit to other sectors, the public sector mobilized large sums in the domestic capital market, to an extent that enabled it to carry out its expenditure despite the smaller volume of unilateral receipts and net credit from abroad. Net credit received by households, businesses, and public sector companies from the public sector declined in 1966, the only increase being in net credit to nonprofit institutions. On the other hand, the public sector borrowed more in 1966 from the financial sectors, a large part of the net increase originating in the banking system. The

<sup>1</sup> Thus, for example, the demand surplus of the private sector as derived from its real transactions is estimated at IL 94 million in 1966 and IL 430 million in 1965, while the estimate derived from its financial transactions is IL 326 million and IL 524 million respectively. The difference between the two estimates stems mainly from errors and omissions in the country's international balance of payments, and only to a small extent from errors in the other sectors' "balance of payments". Nevertheless, both estimates indicate a decline in the private sector demand surplus from 1965 to 1966, although at different rates.

<sup>2</sup> The treatment of Government proceeds from the Absorption Loan differs from that in previous Annual Reports in that they are now recorded as credit received by the Government from the domestic sectors and not as transfer receipts. Data for previous years have been adjusted accordingly. In this connection, see Chapter VII, "Public Sector Operations".

receipt of this credit was one of the major causes of monetary expansion in 1966.<sup>1</sup>

In view of the weakening of aggregate domestic demand, it is difficult to assess the effect of the net credit flows on the demand for goods and services. In the years marked by excess demand in the economy, an increase in net credit was regarded as inducing a corresponding rise in real demand. Therefore, its magnitude was identified as part of the "contribution" of the public sector to the demand pressures originating in the private sector and public sector companies. However, under conditions of economic restraint and reluctance to invest, there is no longer the same close connection between the credit inflow of a sector and its real purchases, as there had been under conditions of excess demand. The smaller net credit outflow of the public sector in 1966 apparently did not completely offset the expansionary effect of the increase in the sector's demand surplus, owing to the relatively large sums mobilized through short-term loans, as explained below.

The reduction of the private sector demand surplus in 1966 was accompanied by a decline in net foreign credit and transfer receipts, a rise in credit granted to real domestic sectors, and a decline in net credit received from domestic financial sectors.

Households expanded their credit to other sectors in 1966, mostly by purchasing various types of liquid financial assets. The main recipients of this flow were businesses (part of the bill brokerage funds), the banking system (various types of bank deposits, especially fixed-term), the public sector (sales of Short-Term Loan certificates), social insurance funds, and insurance companies. This increase in purchases of financial assets took place in a year when foreign unilateral transfers to households and the rate of household saving declined, and was due to a change in the composition of their saving.<sup>2</sup>

The available figures do not show the changes in credit received by households from businesses. In 1966 consumer credit apparently expanded, bringing up the total volume of credit received from this subsector.

The amount received by businesses from domestic sectors rose in 1966, while that from abroad declined; total credit was below the 1965 level. On the other hand, credit extended by businesses to the public sector rose, as apparently did the amount granted to households. Most of the incremental domestic credit received by businesses was short-term bank credit.<sup>3</sup>

<sup>1</sup> It should be noted that expanding the volume of credit from the banking system does not absorb the purchasing power of other sectors, since this does not entail a structural change in their assets. The extension of credit in this case generates its own source of financing—means of payment.

<sup>2</sup> See Chapter XIX, "Saving", section 2.

<sup>3</sup> The figures appearing in Table XVI-4 on credit received by businesses through bill brokerage are apparently overstated. It is reasonable to assume that the amount received from this source in 1966 was similar to that of the previous year.

The banking system lent the public and business sectors considerably more in 1966. In addition, the accumulation of foreign currency balances by the banking system was checked during the year, and the sector became a net recipient of credit from abroad.

### 3. DEMAND SURPLUSES, BY SECTOR

The demand surpluses of the private (business and household) and public sectors developed in opposite directions in 1966, the demand surplus of the former declining and that of the latter rising. This trend began in 1965 and became stronger in 1966 (see Table XVI-2).

The slower expansion of domestic demand in 1965 and 1966 was connected with the nonuniform development of the demand surpluses of the various real sectors. In 1965 there was an increase in the demand surpluses of the public sector, public sector companies, and nonprofit institutions, whereas that of the private sector declined.

The demand surplus of the private sector continued downward in 1966; that of public sector companies and of nonprofit institutions also declined, while the public sector experienced a further increase. The decelerated expansion of demand was reflected in a smaller GNP growth rate in 1965 and no growth whatsoever in 1966, and a reduction in the aggregate demand surplus of the domestic sectors.<sup>1</sup>

The decline in the demand surplus of the private sector may be ascribed to changes in the volume of investment and private income, as well as to changes in the pattern of saving (the rate and composition of saving), but the data do not allow a separate analysis to be made for the two segments of the private sector.<sup>2</sup> There is reason to believe that the demand surplus of both businesses and households declined in 1966, although this cannot be proved quantitatively.

The changes in the demand surplus of the business sector were due to changes in gross investment and gross saving (undistributed profits and provision for depreciation). As regards depreciation, the amount provided annually presumably is on the rise, in proportion to the growth of the capital stock, but there are no data on changes in the volume of retained business earnings. Hence, although investments are known to have fallen off and provision for depreciation probably

<sup>1</sup> From the definition of a demand surplus, it follows that the aggregate demand surplus of the domestic sectors (net of the supply surplus of sectors having one) is identical with the supply surplus of the rest-of-the-world sector—the deficit on current account in the country's balance of payments.

<sup>2</sup> Besides the statistical difficulties in distinguishing between the activities of businesses and households, there is a conceptual problem in distinguishing between the behavioral patterns of these two subsectors because of the large proportion of unincorporated businesses and self-employed in the Israeli economy.

Table XVI-2

DEMAND OR SUPPLY SURPLUSES, BY SECTOR, 1964-66<sup>a</sup>

(IL million)

Sector	Purchases		Sales	Net purchases (1) + (2) - (3)	Transfers		Net transfers (5) - (6)	Demand or supply (-) surplus (4) - (7)
	On current account	On capital account			To domestic sectors	From domestic sectors		
	(1)	(2)			(3)	(4)		
<b>Private business and households<sup>b</sup></b>								
1964	5,611	1,822	—	—	—	—	—	828
1965	6,514	1,801	—	—	—	—	—	430
1966	7,216	1,328	—	—	—	—	—	94
<b>Public sector<sup>c</sup></b>								
1964	2,090	547	231	2,406	687	2,636	1,949	457
1965	2,531	610	255	2,886	840	3,058	2,218	668
1966	2,980	659	324	3,315	1,080	3,519	2,439	876
<b>Public sector companies<sup>d</sup></b>								
1964	779	456	928	307	20	30	10	297
1965	912	484	1,042	354	12	30	18	336
1966	989	384	1,079	294	5	67	62	232
<b>Nonprofit institutions<sup>e</sup></b>								
1964	559	112	129	542	23	407	384	158
1965	694	130	156	668	25	476	451	217
1966	773	116	175	714	21	537	516	198
<b>Social insurance funds and insurance companies<sup>f</sup></b>								
1964	146	10	177	-21	153	154	1	-22
1965	178	9	195	-8	170	191	21	-29
1966	205	10	232	-17	202	214	12	-29
<b>Banking system<sup>g</sup></b>								
1964	271	27	349	-51	47	—	-47	-4
1965	340	16	416	-60	53	—	-53	-7
1966	437	13	526	-76	70	—	-70	-6
<b>Financial institutions<sup>h</sup></b>								
1964	139	7	174	-28	22	—	-22	-6
1965	181	6	234	-47	37	—	-37	-10
1966	238	7	292	-47	38	—	-38	-9
<b>Rest of the world<sup>i</sup></b>								
1964	1,858	—	-3,566	-1,708	—	—	—	-1,708
1965	2,132	—	3,737	-1,605	—	—	—	-1,605
1966	2,459	—	3,815	-1,356	—	—	—	-1,356

<sup>a</sup> The figures for 1964 and 1965 have been revised.<sup>b</sup> Calculated as a residual by deducting the demand surpluses of other sectors from the supply surpluses. Purchases on capital account are not identical with the sector's investments owing to differences in definition.<sup>c</sup> As defined in Chapter VII, "Public Sector Operations", except that sales include interest received.<sup>d</sup> Companies in which the public sector holds at least 25 percent of the equity capital and actively participates in the management.<sup>e</sup> As defined in Chapter VIII, "Nonprofit Institutions".<sup>f</sup> As defined in Chapter XVIII, "Social Insurance Funds and Insurance Companies".<sup>g</sup> Commercial banks, cooperative credit societies, and the Bank of Israel.<sup>h</sup> As defined in Chapter XVII, "Financial Institutions".<sup>i</sup> Sales are identical with imports as recorded in the balance of payments, and purchases with exports.

increased, there is no way of measuring the change in the sector's demand surplus; however, it is reasonable to assume that it shrank appreciably in 1966.

The demand surplus of households apparently also contracted in 1965 and 1966, years which saw a rise in private incomes.

In 1965 incomes expanded rapidly and the rate of household saving also went up. The latter development was not accompanied by a greater propensity to purchase dwellings and durable goods, so that the demand surplus declined.<sup>1</sup> In 1966 the rate of income growth slowed down considerably and the saving rate fell, but it was the change in the composition of saving that apparently brought about the contraction of the sector's demand surplus.

The change in the saving pattern was twofold:

(a) Uncertainty regarding future income and the expectation of price decreases which accompanied the economic slowdown in 1966 caused many households to defer the purchase of real assets (mainly dwellings and durable goods). In addition, the relative yield of liquid financial assets rose, making them more attractive, and hence inducing a shift from real assets to financial assets with a relatively high liquidity.

(b) The changes in income distribution that took place in 1966 apparently also contributed to the increased purchase of financial assets. Earnings of the medium- and high-income employees were not affected by the recession.<sup>2</sup> It is known from saving surveys that this group displays a relatively high propensity to save in the form of financial assets. On the other hand, the recession affected groups with a lower propensity to purchase financial assets. This applies to the self-employed and businesses, a large part of whose saving is in the form of real assets, and to low-income employees, whose propensity to save is in any case low.

While the demand surplus of the private sector declined in 1965 and 1966, there was a sharp increase in the demand surplus of the public sector. After falling slightly in 1964, the public sector demand surplus went up by IL 211 million in 1965 and IL 208 million in 1966. In 1965 the growth countered the contractionary effect of the decline in the private sector demand surplus that year, and it is reasonable to assume that, together with the accompanying rise in the flow of net credit to the domestic sectors, it averted a sharp drop in the GNP growth rate until 1966.

The factors responsible for the expansion of the public sector demand surplus are discussed in detail in Chapter VII, "Public Sector Operations". Here it should be noted that it was connected with a rapid growth of expenditure in

<sup>1</sup> The demand surplus of households is defined as the difference between gross saving and gross investment in real assets.

<sup>2</sup> In 1966 big retroactive wage increments were paid in the sectors employing white-collar workers—the Government, local authorities, nonprofit institutions, public sector companies, and large private companies; an appreciable portion of this type of lump-sum receipt is invested in financial assets.

both years unaccompanied by a corresponding expansion of tax revenue. Although the rise in public sector expenditure and the decline in that of the private sector had opposite effects, it should be pointed out that the private sector trimmed its investments, while the increase in public sector expenditure took place in current account items, so that total capital formation declined considerably.

The expansionary effect of the increased public sector demand surplus in 1966 was partly offset by the smaller volume of net credit granted to other domestic sectors. In 1966 the demand surplus of the sector rose by IL 208 million, and the net credit outflow fell by IL 250 million.

Analysis of the decline in the net credit outflow of the public sector shows that net long-term credit provided to the rest of the economy was only IL 89 million lower than in 1965.<sup>1</sup> The rest of the decline in the credit outflow is explained by the decrease in outstanding Short-Term Loan certificates in 1965, the larger sale of such certificates in 1966, and net changes in other types of short-term credit between the two years.

The contractionary effect on demand of the decline in net credit presumably was not sufficient to offset the expansionary influence of the rise in the sector's demand surplus, since the decline was mostly due to larger sales of the Short-Term Loan to the public, while gross credit for investment financing was not reduced.

The demand surplus of public sector companies, which had risen slightly in 1965, fell off in the year reviewed.

Changes in the demand surplus of this sector are closely connected with fluctuations in purchases on capital account. This is because in recent years the absolute amount of gross saving of the sector has remained fairly constant, so that the changes in annual investment were practically equal to those in the demand surplus.<sup>2</sup> The 1966 decline in capital expenditure took place in housing and other construction, mining and quarrying, manufacturing, water, and electric power, while in transportation and communications outlay remained at the 1965 level.

The reduction of construction activity accounted for about half of the drop in the sector's investment in 1966. This development can be ascribed primarily to the big investment in dwelling stock in 1964 and 1965, which resulted in a surplus supply, and to the weakening of demand because of the smaller volume of immigration and other developments in construction activity.

The smaller investment in other branches was due to the completion of large-scale investment programs by the Dead Sea Works, Electric Corporation, and transport companies, and not to a weakening of local demand.

<sup>1</sup> See Table VII-2 in Chapter VII, "Public Sector Operations".

<sup>2</sup> That gross saving has not changed much suggests a decrease in the profitability of the sector, since provision for depreciation increases with a rise in the sector's capital stock, and only a small percentage of profits is distributed as dividends.

The demand surplus of nonprofit institutions decreased somewhat in 1966, following a sharp rise the year before. The 1965 increase was due to the rapid growth of current expenditure (particularly wages), while transfers from the domestic sectors showed a more sluggish growth. The sector has to resort to large-scale borrowing from domestic sources, in addition to the unilateral transfers from abroad which constitute a permanent source of financing. In 1966 the growth of current expenditure slowed down and purchases on capital account fell somewhat. At the same time, domestic transfers rose more than expenditure, so that the sector's requirements for domestic credit did not increase despite the decline in unilateral receipts from abroad.

#### 4. FINANCING THE DEMAND SURPLUSES<sup>1</sup>

The demand surplus of the economy is financed by unilateral transfers and credit from abroad. Unilateral transfers accounted for 61 percent of the country's capital imports in 1964, about 60 percent in 1965, and 57 percent in 1966. The private sector and nonprofit institutions are the major recipients of these transfers, with the remainder going to the public sector. On the other hand, most of the foreign credit goes to the public sector and public sector companies, and to a lesser extent to the private sector and financial institutions. Until 1965 the banking system extended net credit to the rest of the world, but with the reduction of foreign exchange reserves in 1966, it became a recipient of net credit from abroad. The sectors' sources of finance are summarized in Table XVI-3.

The decline in the demand surplus of the private sector in 1965 and 1966 was connected with the changes in its sources of funds. The amount of net credit extended to other domestic sectors remained virtually constant in both years, while credit from other domestic sectors declined somewhat. In 1966 there was a sharp decrease in the sector's credit receipts from abroad, and unilateral transfers continued to fall off, although to a much smaller extent than in the previous year.

Table XVI-5 shows that net credit received by the business sector declined slightly in 1966, while net credit extended by households rose. However, net credit received by businesses apparently declined more than is shown in the table. Partial figures indicate that part of the increase in bank-negotiated bill credits did not go to the business sector, but to local authorities, nonprofit institutions, and public sector companies.<sup>2</sup> Moreover, the business sector probably

<sup>1</sup> Owing to the magnitude of the errors and omissions item in the country's balance of payments in 1965 and 1966, the discussion in this section should be treated with considerable reserve. The wide divergence in the estimates of the demand surplus in Table XVI-3 as derived from real and from financial transactions originate in these errors and omissions.

<sup>2</sup> Adjusting for bill brokerage would bring down the amount of net credit received by businesses by about IL100 million.

Table XVI-3

FINANCING OF DEMAND SURPLUSES, BY SECTOR, 1964-66<sup>a</sup>

(IL million)

Sector	From rest of world		Domestic sectors		Total net credit received or granted (-) (2) + (3) - (4)	Errors and omissions	Demand or supply (-) surplus (1) + (5) + (6)
	Transfers	Net credit	Net credit received <sup>b</sup>	Net credit granted <sup>c</sup>			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
<b>Private business and households</b>							
1964	686	198	585	620	163	-21	828
1965	601	269	293	639	-77	-94	430
1966	591	135	243	643	-265	-232	94
<b>Public sector</b>							
1964	217	298	297	354	241	-1	457
1965	287	546	241	406	381	—	668
1966	192	438	465	221	682	2	876
<b>Public sector companies</b>							
1964	—	126	196	25	297	—	297
1965	—	2	364	25	341	-5	336
1966	—	-59	285	-17	243	-11	232
<b>Nonprofit institutions</b>							
1964	151	—	7	—	7	—	158
1965	156	—	59	—	59	2	217
1966	137	—	63	—	63	-2	198
<b>Social insurance funds and insurance companies</b>							
1964	—	-2	234	250	-18	-4	-22
1965	—	2	257	286	-27	-2	-29
1966	—	2	299	325	-24	-5	-29
<b>Banking system</b>							
1964	—	-9	284	278	-3	-1	-4
1965	—	-225	374	157	-8	1	-7
1966	—	70	380	451	-1	-5	-6
<b>Financial institutions</b>							
1964	—	71	121	198	-6	—	-6
1965	—	63	164	239	-12	2	-10
1966	—	103	186	298	-9	—	-9
<b>Rest of the world<sup>d</sup></b>							
1964	-1,054	—	—	—	-682	28	-1,708
1965	-1,044	—	—	—	-657	96	-1,605
1966	-920	—	—	—	-689	253	-1,356

<sup>a</sup> The figures for 1964 and 1965 have been revised.<sup>b</sup> Column totals in Table XVI-5, less credit from the rest of the world.<sup>c</sup> Row totals in Table XVI-5, less credit to the rest of the world.<sup>d</sup> Column 6 is identical with the item "net errors and omissions" in the balance of payments.

granted more net credit to households in 1966 than in previous years; this was connected with an improvement in consumer credit terms and a reduction in down payments by households on account of dwellings and other purchases. Hence the relatively slight decrease in the credit receipts of businesses in 1966—a year when their investments declined appreciably—can be explained by the increase in net credit granted to other sectors<sup>1</sup> (particularly households and the public sector).

Unilateral transfers have not covered the demand surplus of the public sector since 1962. In order to finance its real operations and grant credit to the rest of the economy, the sector has required additional credit from abroad and from domestic sources (including the banking system). Unilateral foreign transfer receipts rose by IL 70 million in 1965, and declined by IL 95 million in 1966.

Net credit received by the public sector from domestic and foreign sources increased by about IL 140 million in 1965 and IL 301 million in 1966.<sup>2</sup> The weight of domestic sources went up in 1966, after dropping the year before.<sup>3</sup> Credit from domestic sectors grew mainly because of the increase in net proceeds from the Short-Term Loan and in bank credit.

The credit obtained by the public sector from the banking system was one of the factors in the monetary expansion of 1966. Credit to the public sector was stepped up under the expansionary monetary policy adopted by the Bank of Israel in 1966, and therefore the sector required less credit from abroad.<sup>4</sup>

The decline in the demand surplus of public sector companies in 1966 was accompanied by the repayment of a considerable amount of foreign debt. Consequently, the amount of funds raised from domestic sectors declined less than the demand surplus. The foreign debt repayment, amounting to IL 59 million, was mostly on account of credits received by Zim and the Dead Sea Works in previous years.

Foreign transfer receipts of nonprofit institutions contracted in 1965, thereby accelerating the downward trend in the share of this source in financing the sector's demand surplus. The increase in expenditure in 1965 and 1966, without a corresponding rise in transfers and income from the sale of services, compelled the sector to resort to domestic credit in order to finance its demand surplus.

## 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

<sup>1</sup> Or by the decrease in net credit received by businesses.

<sup>2</sup> Column (5) in Table XVI-3.

<sup>3</sup> Net public sector credit from abroad declined by IL 108 million in 1966.

<sup>4</sup> The increase in interest rates in the international money market in 1966 may have prompted the public sector to substitute domestic for foreign credit.

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-3, since the most significant aspect of their operations is not their total credit inflow and outflow (which are necessarily of fairly similar magnitudes), but the sectorial composition of each. In general, money flows through the financial sectors are ignored in cases where the financial institution does decide independently on the manner of raising and allocating its funds. Thus, for example, credit given by banking and financial institutions from Government deposits is not considered a flow of money through the institutions, but as credit extended by the Government directly to the borrowing sectors. Owing to statistical difficulties, it is not always possible to identify this type of transaction.

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.

#### (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 money-flows system are classified under sources of funds, though they are essentially different from the sources of the other financial sectors.

Secondly, until 1965 this sector was a net lender to the rest of the world, since the accumulation of foreign currency balances by the Bank of Israel is, conceptually speaking, credit granted to the rest-of-the-world sector.

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 other real sectors,<sup>1</sup> and the banks' mediation in such transactions does not find expression in the money flows. This presentation, though formally correct, suffers from the drawback of ignoring the key role of the banking institutions in mobilizing and allocating the funds.

#### (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 inter-

<sup>1</sup> Most of the credit originating in the bill brokerage trade goes to the business sector. It appears that in 1966 local authorities, nonprofit institutions, and public sector companies also obtained funds in this manner.

mediaries when it comes to allocating them, since most of their investments are subject to Government control. The Government's predominance in the bond market largely stems from its channeling of monies accumulated in social insurance funds and insurance companies—half of the investment of social insurance funds is in securities of Histadrut enterprises and institutions and half in Treasury-approved securities. Most of the insurance company reserves are invested in securities of the Government or of public sector companies.

Investments of social insurance funds do not flow directly to the receiving real sectors, but mainly through financial and banking institutions.

(c) *Financial institutions*

This group of financial intermediaries raises most of its funds by issuing bonds to social insurance funds, and obtaining credit from abroad and from the banking system.

The Government largely directs these sources of finance, regulating their amount and determining their price and allocation. Unlike financial institutions in the western countries, which mobilize a large part of their funds by soliciting savings from households, financial institutions in Israel obtain only a small percentage of their funds in this manner. The business sector is the biggest recipient of financial institution credit.

(d) *The securities market*

The securities market also fulfils a role of financial intermediation, particularly through its new issue activity. In Israel this is mainly a bond market, although an appreciable amount of shares were issued in the years 1962–64. Granting approval for bond issues is one of the means by which the Government controls the allocation of funds through the securities market. Another is directing the purchase of bonds by social insurance funds, insurance companies, and banks administering saving schemes.

Israel's long-term capital market is characterized by two forms of Government intervention: (1) the mobilization by the public sector of a large amount of finance in Israel and abroad and its direct allocation, and (2) controlling the price and destination of the credit flows through financial intermediaries.

As regards short-term credit, market forces play the decisive role in its allocation. The allocation of bill-brokerage credit and ordinary bank credit is not subject to direction; the price of the former is determined by supply and demand conditions, while that of bank credit is limited by the Interest Law.

## 6. CREDIT FLOWS

The financial sectors receive and give credit in approximately equal amounts, since they act as intermediaries between the nonfinancial sectors (including the rest of the world). Of the real domestic sectors, only one grants more credit than

it receives—households. The rest-of-the-world sector likewise extends far more credit to the domestic sectors than it receives from them. The other non-financial sectors—the public sector, private business enterprises, public sector companies, and nonprofit institutions—are characteristically recipients of credit, although the public sector acts as a financial intermediary in addition to its real transactions.

When examining the credit relationships between the various economic sectors, it is important to distinguish between gross and net credit flows (Tables XVI-4 and XVI-5). Intersectorial credit flows are often bilateral. Thus, the public sector borrows from households by issuing bonds, and also lends them money to buy homes. Social insurance funds receive credit from businesses in the form of severance pay reserve accumulation, and grant them credit as part of their approved investments. The same applies in other cases. The magnitude of the gross credit flows is of interest, but in order to clarify the intersectorial credit relationships, it is necessary to offset the credit outflow against the credit inflow of each pair of sectors. It should be stressed that credit includes not only loans granted but also repayment of loans received in the past, and this too is clearly reflected in the net credit-flows structure.

The credit-flows system (Tables XVI-4 and XVI-5) should be analyzed with caution, particularly in drawing conclusions about the private sector and its two components. This is because of the magnitude of the errors and omissions item in the country's balance of payments in 1965 and 1966, and because of the possibility that there were big unidentified changes in 1966 in the credit flows between private businesses and households. Following are the main developments in the credit-flows system in 1966.

#### (a) *Households*

Households in 1966 provided more gross credit to the financial and real sectors than in 1965. Gross credit received by households from the real sectors (mainly the public sector) rose, while credit receipts from the financial sectors remained unchanged. Households extended credit to the other sectors by increasing their accumulation in social insurance funds and insurance companies, purchasing Absorption, Short-Term, and Development Loan certificates from the Government, increasing their bank deposits,<sup>1</sup> and buying bills through banks. On the other hand, credit from the public sector (for housing purposes) rose, as apparently did credit from the business sector.

Households provided net credit to the public sector (after having been recip-

<sup>1</sup> Mainly Pazak, Tamam, demand, and time deposits.

**Table XVI-4**  
**GROSS INTERSECTORIAL CREDIT FLOWS, 1965<sup>a</sup>-66**  
 (IL million)

Borrowing sector	Public sector	Public sector companies	Nonprofit institutions	Private business	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
Lending sector											
Public sector											
1965	×	319	15	102	148	584	306	-96	—	1	795
1966	×	276	18	133	191	618	352	-86	—	7	891
Public sector companies											
1965	54	×	—	89	10	153	90	1	4	40	288
1966	72	×	—	55	6	133	101	12	6	46	298
Nonprofit institutions											
1965	3	—	×	3	6	12	—	6	—	—	18
1966	-11	—	×	4	6	-1	—	-1	—	3	1
Private business											
1965	3	64	16	×	<sup>b</sup>	83	50	80	30	21	264
1966	83	72	2	×	<sup>b</sup>	157	17	93	36	9	312
Households											
1965	118	32	26	161 <sup>c</sup>	×	337	18	329	291	47	1,022
1966	253	35	6	247 <sup>c</sup>	×	541	15	342	329	29	1,256

Rest of the world											
1965	852	92	—	337	<sup>b</sup>	1,281	×	112	2	63	1,458
1966	790	42	—	164	<sup>b</sup>	996	×	69	2	104	1,171
Banking system											
1965	-2	13	9	98	2	120	337	×	—	51	508
1966	166	18	24	224	25	457	-1	×	—	79	535
Social insurance funds and insurance companies											
1965	34	49	9	47	34	173	—	47	×	133	353
1966	67	48	14	26	30	185	—	63	×	154	402
Financial institutions											
1965	114	60	2	100	72	348	—	21	-1	×	368
1966	153	50	—	115	74	392	1	42	5	×	440
Total credit received											
1965	1,176	629	77	937	272	3,091	801	500	326	356	5,074
1966	1,573	541	64	968	332	3,478	485	534	378	431	5,306
Errors and omissions <sup>d</sup>											
1965	—	-5	2	-94	—	—	96	1	-2	2	—
1966	2	-11	-2	-232	—	—	253	-5	-5	—	—

<sup>a</sup> The figures for 1965 have been revised.

<sup>b</sup> No data are available on credit flows between these sectors.

<sup>c</sup> Represents only part of the credit granted—namely, the change in the balance of the bill brokerage trade. See text for further details.

<sup>d</sup> The errors and omissions in the rest-of-the-world column are identical with the net errors and omissions item in the country's balance of payments.

Table XVI-5  
NET INTERSECTORIAL CREDIT FLOWS, 1965<sup>a</sup>-66  
(IL million)

Borrowing sector	Public sector	Public sector companies	Nonprofit institutions	Private business	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											
1965	×	265	12	99	30	406	—	—	—	—	406
1966	×	204	29	50	-62	221	—	—	—	—	221
Public sector companies											
1965	—	×	—	25	—	25	—	—	—	—	25
1966	—	×	—	-17	—	-17	—	—	—	—	-17
Nonprofit institutions											
1965	—	—	×	—	—	—	—	—	—	—	—
1966	—	—	×	—	—	—	—	—	—	—	—
Business enterprises											
1965	—	—	13	×	<sup>b</sup>	13	—	—	—	—	13
1966	—	—	-2	×	<sup>b</sup>	-2	—	—	—	—	-2
Households											
1965	—	22	20	161 <sup>c</sup>	×	203	18	327	257	—	805
1966	—	29	—	247 <sup>c</sup>	×	276	15	317	299	—	907

Rest of the world											
1965	546	2	—	287	<sup>b</sup>	835	×	-225	2	63	675
1966	438	-59	—	147	<sup>b</sup>	526	×	70	2	103	701
Banking system											
1965	94	12	3	18	—	127	—	×	—	30	157
1966	252	6	25	131	—	414	—	×	—	37	451
Social insurance funds and insurance companies											
1965	34	45	9	17	—	105	—	47	×	134	286
1966	67	42	14	-10	—	113	—	63	×	149	325
Financial institutions											
1965	113	20	2	79	25	239	—	—	—	×	239
1966	146	4	-3	106	45	298	—	—	—	×	298
Total credit received											
1965	787	366	59	686	55	1,953	18	149	259	227	2,606
1966	903	226	63	654	-17	1,829	15	450	301	289	2,884
Errors and omissions <sup>d</sup>											
1965	—	-5	2	-94	—	—	96	1	-2	2	—
1966	2	-11	-2	-232	—	—	253	-5	-5	—	—

<sup>a</sup> The figures for 1965 have been revised.

<sup>b</sup> No data are available on credit flows between these sectors.

<sup>c</sup> Incomplete data (see note <sup>c</sup> to Table XVI-4).

<sup>d</sup> The errors and omissions in the rest-of-the-world column are identical with the errors and omissions item in the country's balance of payments.

ients of net credit in 1965), social insurance funds, insurance companies, and businesses.<sup>1</sup> The financial institutions extended net credit to households.

(b) *Business enterprises*

There was some decline in the gross credit flow to business firms in 1966, as well as a change in its composition. Credit from the rest of the world decreased considerably, while that from the banking system increased.<sup>2</sup> Credit granted by the sector to households apparently rose in 1966, although no data are available on the amount given by businesses to households and that received from households, except through bill brokerage.

(c) *Public sector*

Gross credit receipts of the public sector from domestic sectors (except non-profit institutions) were much larger than in 1965. The amount of gross credit given to domestic real sectors held steady, although its composition underwent a change: credit to public sector companies declined, and that to businesses and households rose. Credit from the rest of the world decreased in 1966, while the sector's debt repayment to the rest of the world increased. As a consequence, net credit receipts from abroad fell by IL 108 million. Most of the sector's incremental credit originated in the banking system and the private sector.

The key position of the public sector in the credit-flows structure is not fully reflected in the available figures. Its dominant role derives from the Government's intervention in the raising and allocating of funds by the financial intermediaries, as described in the previous section.

(d) *Public sector companies*

In 1966 the public sector companies received less gross and net credit from both the public and the financial sectors. The amount of foreign loans repaid in 1966 by public sector companies exceeded new credit receipts. Credit from other sectors mostly originates in various types of short-term financing.

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

This sector provided less gross and net credit to the domestic real sectors than in 1965. The decline in foreign exchange reserves held by the banking system is expressed as net credit received from abroad, whereas in the previous year the

<sup>1</sup> As already noted, there are no data on credit transactions between households and business enterprises, except for the bill brokerage trade. The figures in Tables XVI-4 and XVI-5 overstate the latter type of credit granted by households to businesses and do not reflect the increase that apparently took place in credit received by households from business enterprises.

<sup>2</sup> The decline in credit received by the sector from abroad was closely connected with the contraction of business investments, but it is difficult to determine which was the cause and which the effect.

increase in such reserves was expressed as credit granted to the rest of the world. The financial institutions mobilized more funds abroad in 1966, while public sector companies repaid loans to the rest of the world.

(f) *The banking system*

In 1966 the banking system considerably increased credit to domestic sectors, a reflection of the expansionary monetary policy instituted by the Bank of Israel. The public and business sectors were the main recipients of the incremental credit. The banking system received less credit from the rest of the world than in 1965. On the other hand, there was no accumulation of foreign currency assets in 1966 (after an accumulation of IL 337 million in 1965). Thus, the banking system became a net borrower from, instead of a net lender to, the rest of the world.

(g) *Social insurance funds and insurance companies*

The credit received by these institutions originates almost entirely from households, in the form of contributions to provident and pension funds and premium payments to life insurance companies. Credit from the private business sector represents the accumulation of severance pay funds in a number of funds operated by insurance companies and banks.<sup>1</sup> In 1966 this accumulation continued to grow. Credit to the public sector, banking system, and financial institutions rose in 1966, while that to households and public sector companies remained unchanged and credit to business enterprises declined.<sup>2</sup>

It should be noted that the public sector directs most of the credit given by social insurance institutions, and to a lesser extent, that from insurance companies.

(h) *The financial institutions*

The social insurance funds and the rest of the world remained the major sources of credit for the financial institutions. In the last two years the 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 stated, as credit granted directly by the Government to the final borrowers.

<sup>1</sup> The severance pay funds administered by banks and insurance companies are classified here as social insurance institutions.

<sup>2</sup> The decline was connected with an issue of financial institution bonds designed to enable employers to pay their debts to the funds. If this transfer is deducted, it turns out that in 1966 the funds gave businesses net credit in the sum of IL 10 million. See Chapter XVIII, "Social Insurance Funds and Insurance Companies".

In the last two years financial institutions raised funds from households by selling deposits of building companies and contractors earmarked for the granting of mortgage loans to home buyers. The amount received in 1966 in this manner was lower than in 1965.

The amount of net credit made available by these institutions to the public sector continued to increase in the year reviewed. Net credit to public sector companies declined, while that to businesses and households increased.