CHAPTER XVII

MONEY SUPPLY, CREDIT, AND THE BANKING INSTITUTIONS

1. Main Developments

The government and the Bank of Israel injected a staggering IL 6 billion of liquidity into the economy during 1974. But much of it was absorbed by the sharp contraction of foreign exchange reserves (until the devaluation of the IL in November); as a result, the money base broadly defined expanded by only IL 1.1 billion, or 16 percent, as against 27 percent in 1973, and the money supply by 18 percent (32 percent in 1973).

At the beginning of the year the balance on goods and services account was expected to become increasingly adverse because of rising world prices, an increase in Israel's imports in the wake of the war and national emergency, and a shrinkage of capital imports, with the outcome being an external drain liable to have severe deflationary effects. In order to avert this, the government and the Bank of Israel conducted a reflationary monetary policy.

In the course of the year there were recurring expectations of a devaluation of the Israeli pound and an acceleration of inflation, which made speculative purchases of value-linked bonds and foreign currency seem very attractive. This induced economic units to shed part of their liquid asset holdings in order to finance the speculative demand, which took the form of purchases of linked bonds, the advancing of imports, the holding up of the transfer of export proceeds, and authorized purchases of foreign currency. If the liquidity injection had been smaller, the volume of such speculative transactions conceivably would also have been smaller. Since it is hard to steer a liquidity injection toward certain activities and away from others, the authorities feared that if they pumped too little liquidity into the economy this would affect productive more than speculative activity.

In analyzing monetary developments during the year three subperiods can be distinguished. The first is from January to July, which saw a continuation of the trends begun in the previous October. During these months there was a massive

liquidity injection by both the government[1] (IL 1,173 million) and the Bank of Israel[2] (IL 1,612 million). The amount pumped in by the government was actually much higher than indicated here, but part of it was siphoned off through the sale of bonds to the public. On the other hand, there were recurring strong devaluation expectations during this subperiod, and capital imports failed to cover all of the current deficit. The financing of the import surplus and the speculative demand for foreign currency assets generated a IL 3,789 million external drain.[3] The net result was the contraction of the money base by about IL 1 billion, but the effect of this on the money supply was mitigated by the unprecedented liquidity deficiencies incurred by the banks, so that the money supply remained fairly stable during the year.

The second subperiod lasted from August until the devaluation of the Israeli pound at the beginning of November. The Bank of Israel took action to reduce the large liquidity deficiencies of the banking institutions, mainly by altering the composition of the directed credit funds and increasing the share of rediscounts; at the same time it imposed a ceiling on nondirected credit in order to head off a monetary expansion. The outcome was a IL 1,307 million growth of the money base. During this period sales of linked bonds slackened and the government injected IL 2,940 million of liquidity. The private sector continued to purchase foreign currency, and there was a IL 2,080 million external drain. As a consequence, the money base broadly defined swelled by IL 1,139 million.

The postdevaluation period witnessed a change in the monetary picture: the government and the Bank of Israel began to mop up liquidity (IL 220 million), while the public began to bring back some of the foreign currency it had transferred abroad and to convert foreign currency deposits; this generated an external infusion of IL 1,027 million. The money base therefore expanded during this period by IL 807 million.

The growth pattern of the money base during the year was reflected in the reduction of the money supply at an annual 2 percent rate in the first subperiod and an average monthly increase of some 3 percent in the second and 4.7 percent in the third.[4] Over the year as a whole the money supply rose 20 percent on an annual

[1] Including the influence of government and National Institution operations and import deposits (see Table XVII-3).

[2] In the form of rediscounts, open-market operations (including the decrease in Short-Term Loan holdings), exemptions from the liquidity requirements, recognized liquidity deficiencies, and other local currency items.

[3] Net purchases of foreign currency by the private sector and the accumulation of foreign currency deposits.

[4] If the window-dressing of the commercial banks' balance sheets is ignored, the average monthly increase during this period was only 2.8 percent. Seasonally adjusted data indicate

average and 18 percent in its December levels.

The implicit price deflator of domestic uses was up 38 percent in 1974, and there was a real increase of 2-3 percent in the product of the private economy. At the same time, with the acceleration of inflation and the reshuffling of the public's liquid asset holdings, the share of means of payment in the portfolio declined, reflecting the diminished demand for holding money. This is also indicated by the 16 percent increase in the velocity of demand deposits, which made it possible to maintain the real volume of transactions with a smaller stock of money. Nevertheless, no shortage of liquidity cropped up during the year, thanks to the increased liquidity of bonds, at least some of which in effect became part of the liquid assets portfolio.

In 1974 not only did the return on bonds outpace the rise in most other financial asset yields, but there was an increase in their liquidity. This made it pay to hold bonds even for relatively short periods and permitted a rapid switch from this instrument to money on the part of both households (through sales on the Stock Exchange) and the economy as a whole, thanks to the large volume of monthly redemptions. This trend weakened in the second half of the year, particularly in August (see the discussion in Chapter XIX, "The Securities Market").

Part of the incremental money injected into the economy during the year reviewed was used to buy bonds and foreign currency assets, while another part flowed to the commodity and service markets (both local production and imports). Thus there was apparently no great overdemand for domestic goods and services. It should be stressed that the advance in prices during the year was largely due to the lifting of subsidies, the devaluation of the IL, and the rise in foreign prices, and not to excess domestic demand; but even so, some monetary expansion was necessary for financing the previous volume of real activity at the new inflation-swollen price level. Further evidence of the existence of a relative abundance of liquidity in 1974 can be found in the development of the secondary market for index-linked bonds: in most months of the year (except February, when there was a worsening of the terms of new bond issues, and in August and September) yields to maturity were stable and relatively low.

As the year opened the economy was still on an emergency footing but starting to return to normal. Monetary policy was therefore designed to prevent the creation of a shortage of liquidity. The Bank of Israel introduced a number of expansionary measures, the most important of which were as follows: (a) the penalty rates for liquid asset deficits incurred by the commercial banks were not restored to their prewar level despite the steep increase in the deficits; (b) the directed credit funds were restructured in order to enlarge the banks' freely loanable funds; and (c) the

similar orders of magnitude (see Table XVII-6).

liquidity ratios on time deposits were scaled down. At the same time the government also adopted a policy with an expansionary monetary effect, in contrast to the usual pattern in the final quarter of the fiscal year. In the first three months of 1974 it became clear that the economy was returning to normal faster than expected, and that the liquidity injection was also financing a large volume of speculative transactions in linked bonds and especially foreign currency. The Bank of Israel thereupon took action in the second quarter to moderate the liquidity inflow. It restored the fines for liquidity deficiencies to their previous level and reintroduced the obligatory import deposits. These measures began to leave their impress in May, but at the beginning of June there was a renewed wave of devaluation expectations, and the banks again stepped up their credit faster than their loanable funds permitted. The ensuing liquidity deficiencies grew enormously, and at the beginning of July stood at an all-time high of IL 1.1 billion.

At the beginning of August the Bank of Israel decided to clamp a ceiling on bank credit for a three-month period in order to arrest its rapid swelling. This had the desired effect: the volume of such financing did not exceed the ceiling and in fact fell short of it. The accelerated conversion of local into foreign currency continued, but this did not have a contractionary monetary effect; after the announcement of the new economic policy in July the government's operations were supposed to have an absorptive effect, but instead it pumped in IL 1.9 billion, partly because of the unexpected drop in sales of linked bonds. During this period the Bank of Israel injected IL 1.3 billion, but most of it was intended to cover the commercial banks' liquidity deficiencies and hence did not fuel the monetary expansion.

It was against this backdrop that the Israeli pound was devalued on November 9 by 43 percent. This stemmed the purchase of foreign currency, and the private sector even began to return part of the funds it had transferred abroad. In the last two months of the year, as well as the early part of 1975, the private economy was a net seller of foreign currency. During this period steps were also taken to brake the monetary expansion, including the hiking of the fines for liquidity deficits, extension of the credit freeze for another three months, and the raising of the commercial banks' contribution to the directed credit funds from their freely loanable resources.

From the devaluation until the end of the year the money base broadly defined grew by IL 810 million. The government was a moderating factor, mopping up IL 540 million, thanks mainly to a large bond flotation. The Bank of Israel injected IL 313 million, while the private sector's foreign currency conversions (foreign transfer receipts and deposits) again became an expansionary factor; during this period the money base grew by IL 1,030 million.

Although the devaluation was not accompanied by specific measures to avoid the conversion of Pazak restitution and Tamam deposits, this did not take place on a

very large scale—the latent "time bomb" in the form of over IL 8 billion of deposits failed to explode.

In other foreign currency deposits (mainly Pazak nonrestitution and Natad) the rate of conversion was larger, but the total amount withdrawn by year's end was a relatively small IL 680 million. In adjusting its liquid assets portfolio the public continue to disinvest in time deposits and the Short-Term loan—by IL 224 million and IL 215 million respectively. On the other hand, approved saving scheme deposits continued to bulge in 1974—by IL 2 billion, after a IL 660 million increase in 1973.

The balance of local currency credit soared 49 percent during the year to reach IL 9.6 billion. Nondirected credit was up 32 percent, and directed credit by 82 percent. The growth did not proceed at an even pace: during the first seven months, until the freezing of nondirected credit, such financing expanded by IL 1.5 billion, or at a 58 percent annual rate, while directed credit increased by only IL 500 million, or a 40 percent annual rate. After the credit freeze went into force the balance of nondirected credit started to shrink, but directed credit expanded strongly, moving up at a 113 percent annual rate in the last five months of the year. Outstanding foreign currency credit granted to the public, less devaluation increments, grew by IL 1,600 million (63 percent) during the year.

2. The Influence of Monetary Developments on the Economy

Monetary policy in 1974 had to contend with a crucial problem. At the beginning of the year the authorities expected an increase in the balance of payments deficit on current account because of a rise in world prices and the stepping up of imports in the wake of the war and national emergency. There were fears that these two factors, along with an anticipated sagging of capital imports, would cause a heavy depletion of foreign currency balances, and that the ensuing sizable external drain would have severe deflationary effects. An expansionary monetary policy was therefore called for, since during the period of emergence from the national emergency and mass mobilization of reserves it was necessary to prevent a possible shortage of liquidity from inhibiting the restoration of normal economic activity. But already at the beginning of the year, and even more so in subsequent months up to November, there were recurring waves of inflationary and devaluation expectations, which made speculation in linked bonds and foreign currency very tempting. This placed the authorities in a dilemma, for the liquidity injection which seemed essential for facilitating the restoration of normal economic activity was also likely to help finance speculative transactions. But unfortunately it was not possible to ensure that the monetary expansion would be directed only to desirable activities and away from

Table XVII-1

CHANGES IN MAJOR MONETARY AGGREGATES, 1972-74

(IL million)

Period	Balance at end of period	Change in balance		Average balance	Change in average balance	
		IL m.	%		IL m.	%
			Money supply			
1972	5,587	1,246	28.7	5,041	1,165	30.1
1973						
Jan.–Oct.	7,133	1,546	27.7	6,118		
Nov.–Dec.	7,392	259	3.6	7,298		
Entire year	7,392	1,805	32.3	6,315	1,274	25.3
1974						
Jan.–Oct.	7,970	578	7.8	7,377	1,259[a]	20.6[a]
Nov.–Dec.	8,722	752	9.4	8,514	1,216[b]	16.7[b]
Entire year	8,722	1,330	18.0	7,566	1,251	19.8
			Unlinked liquid assets of the public[c]			
1972	10,166	2,172	27.6	9,073	2,012	28.5
1973						
Jan.–Oct.	11,521	1,355	13.3	10.595		
Nov.–Dec.	11,594	73	0.6	11,545		
Entire year	11,594	1,428	14.0	10,754	1,681	18.5
1974						
Jan.–Oct.	11,504	–90	–0.8	11,000	405[a]	3.8[a]
Nov.–Dec.	12,485	981	8.5	12,177	632[b]	5.5[b]
Entire year	12,485	891	7.7	11,196	442	4.1
			Money base (broadly defined)[d]			
1972	5,482	1,307	31.3	4.972	1,426	40.2
1973						
Jan.–Oct.	6,918	1.436	26.2	5,885		
Nov.–Dec.	6,942	24	0.3	7,004		
Entire year	6,942	1,460	26.6	6,071	1,099	22.1
1974						
Jan.–Oct.	7,378	436	6.3	6,465	580[a]	9.8[a]
Nov.–Dec.	8,064	686	9.3	7,958	954[b]	13.6[b]
Entire year	8,064	1,122	16.2	6,713	642	10.5

[a] January–October 1974 compared with January–October 1973.
[b] November–December 1974 compared with November–December 1973.
[c] Money supply, time deposits in Israeli currency, and Short-Term Loan.
[d] Currency in circulation and the banking institutions' liquid assets (including exemptions from the liquidity requirements).

SOURCE: Money supply — Table XVII-6; unlinked liquid assets — Tables XVII-6 and XVII-7; money base — Table XVII-4.

undesirable ones. The massive injection therefore permitted not only the return of the economy to normal but to some extent also the aforementioned speculative transactions. Conceivably these would have been smaller in scope had the liquidity injection not been so large.

Since the beginning of the year—in fact since October 1973— there has been a sizable liquidity injection: the government and the Bank of Israel pumped in IL 820 million in the first quarter of 1974 and a further IL 1,460 million in the next three months.[5] In the second half of the year the inflow was stepped up even more, and was accompanied by some changes in its sources. Over the year as a whole the figure came to IL 6 billion (compared with IL 1.8 billion in 1973). The money base broadly defined expanded by only IL 1.1 billion, and the money supply by 18 percent in the course of the year and by 20 percent on an annual average.

From the viewpoint of monetary developments the year reviewed falls into three distinct subperiods. During the first, from January through July, there was a large liquidity injection, which was more than absorbed by the adverse balance on goods and services and the speculative demand for bonds and foreign currency. The broadly defined money base shrank by about IL 1 billion, so that the big increase in the banks' liquidity deficiencies notwithstanding, the money supply contracted during this period by IL 96 million (1.3 percent). Part of the incremental liquidity flowed to the financial assets and part to the commodity market. This greatly eased the pressure on the latter market—prices here would undoubtedly have risen much more than they actually did had all the incremental liquidity been diverted to it.

During the second subperiod, from August until the devaluation of the Israeli pound in November, the authorities continued to pump in liquidity, and at an even faster rate, besides imposing a ceiling on nondirected credit. During this period the Bank of Israel injected IL 1,307 million, but approximately IL 1 billion was intended to cover the banks' liquidity deficiencies and did not fuel a renewed monetary expansion; the net expansionary effect therefore amounted to only some IL 300 million. During this period the government injected IL 2,094 million (largely because sales of new bond issues plummeted after the freezing of bank credit). The foreign currency market siphoned off IL 2.1 billion, not only because of the current balance of payments deficit but also because of the speculative demand for foreign currency, which mounted at the end of this period; as a result, the broadly defined money base swelled by IL 1.3 billion. This period also saw a heavier demand for money. Despite the sharp contraction of the banks' liquidity

[5] These data assume, as usual, that the sale of government bonds had an absorptive effect. But given the prevailing market conditions and the characteristics of these bonds, it is not at all clear how much of an absorptive effect their sale actually had this year.

deficiencies, the expansion of the money base permitted the money supply to grow by 9.2 percent, or at a 37 percent annual rate.

The devaluation of the IL at the beginning of November again changed the pattern of monetary expansion. The large-scale injection of liquidity by the government and the Bank of Israel came to an end, and the conversion of foreign currency led to a renewed external infusion. From the date of the devaluation until the end of the year the government and the Bank of Israel mopped up IL 220 million, but because of the external infusion—a shift from foreign currency to Israeli currency assets to the tune of IL 1 billion—the broadly defined money base grew by IL 800 million in the last two months of the year and the money supply by IL 752 million (9.4 percent).

We see, then, that in the course of the year the money supply expanded at an accelerating pace, but it still trailed behind the growth of nominal domestic uses because of the rising rate of inflation, which induced a more "economical" use of money. This is suggested by two indicators of the circulation velocity of money: the velocity of demand deposits increased 16 percent and that of the total money supply measured in relation to the national product was up 22 percent. It follows that, even though the money supply rose more slowly than domestic uses, there was no abnormally excess demand for money, thanks to its faster circulation velocity. In addition, during the past two years there was an increase in the public's linked bond holdings and in the liquidity of such paper;[6] consequently, the economy's liquid assets portfolio did not shrink despite the slower growth of the money supply and the decline in the other components of the portfolio—time deposits and the Short-Term Loan. Indeed, the secondary market for bonds, which is a barometer of the money market situation, confirms our conclusion about the absence of a liquidity shortage. Yields to maturity in this market were fairly low this year, hovering around 3 percent (not counting linkage differentials), apart from a few brief subperiods (especially after the imposition of the credit freeze in August and the introduction of less favorable bond issue terms in February). The short-lived yield upturns coincided with temporary credit shortages, but in general the bond market did not seem to show any signs of a liquidity shortage.

In recent years money has surrendered its exclusive status as a liquid financial asset, as other assets have increasingly acquired this characteristic, but it has managed to preserve its unique function as a medium of exchange. In other words, while

[6] The reference is to an assured positive return even on short-term investments and the ability to convert the bonds into cash easily and without any loss in the case of both households (through the secondary bond market) and the economy as a whole (thanks to the large volume of redemptions).

Table XVII-2

INDICATORS OF THE TURNOVER VELOCITY OF LIQUID ASSETS HELD BY THE PUBLIC, 1971-74

	Average velocity of demand deposits[a]	Annual average velocity relative to GNP[b]	
		Money supply	Money supply and unlinked assets
1971	23.0	6.01	3.30
1972	24.5	5.91	3.28
1973			
Jan.-Sept.[c]	26.1	0.00	0.00
Entire year	24.2	5.99	3.52
1974			
April-Dec.[c]	30.1		
Entire year	28.7	6.96	4.71
		Annual average velocity relative to the economy's resource uses[d]	
1971		8.79	4.83
1972		8.68	4.82
1973		9.07	5.33
1974		11.05	7.47
		Annual average velocity relative to the economy's domestic resource uses[e]	
1971		6.73	3.69
1972		6.60	3.67
1973		7.04	4.14
1974		8.62	5.83

[a] Total debits to local-currency demand deposits in banks, divided by the annual average volume of these deposits.

[b] The gross national product at current prices (based on the effective exchange rate), divided by the annual average volume of the two aggregates.

[c] A period of normal economic activity (i.e. excluding the war and national emergency).

[d] The gross national product at current prices, plus the import surplus net of ships and aircraft and direct defense imports (both GNP and the import surplus are based on the effective exchange rate), divided by the annual average volume of the two aggregates.

[e] As defined in note [d], excluding exports.

SOURCE: Velocity of demand deposits—Department of the Examiner of Banks, Bank of Israel; money supply — Table XVII-6; unlinked assets — Table XVII-7; GNP and total and domestic resource uses — Table II-1.

Table

INFLUENCE OF THE PUBLIC AND PRIVATE SECTORS ON

(IL million; [+] denotes an

	1973	1974					
		Jan.	Feb.	March	April	May	June
Government and National Institution operations[a]	461	-387	157	250	423	385	165
Import deposits	81	21	19	18	10	19	-62
Foreign currency sales by the private sector[b]	227	-696	-308	-293	-437	-293	-641
Foreign currency credit to the private sector	486	-53	-36	-15	101	122	87
Change in foreign currency deposits of the public[c]	-590	-114	-130	-173	25	-64	-100
Private sector conversions	123	-863	-474	-481	-311	-235	654
Israeli currency credit to the private sector	58	91	48	194	-60	-34	89
Open-market operations	308	127	48	49	20	26	—
Other factors	268	103	197	-142	75	60	-79
Total increase in money base narrowly defined	**1,299**	**-908**	**-5**	**-112**	**157**	**221**	**-541**
Liquidity exemptions	140	121	-34	30	32	76	-1
Recognized liquidity deficiencies	21	10	2	—	-3	32	-26
Total increase in money base broadly defined	**1,460**	**-777**	**-37**	**-82**	**186**	**329**	**-568**

[a] Net withdrawals from the Bank of Israel by the government (excluding interest payments), plus net sales of foreign currency to (or minus net purchases of foreign currency from) the Bank of Israel by the government.

[b] The increase (or decrease) in net foreign currency assets at the Bank of Israel, less (plus)

money is still the foremost asset for implementing business transactions, for holding liquidity it has increasingly become the practice to use such additional assets as time deposits, the Short-Term Loan, and especially bonds linked to the consumer price index. The ability to quickly convert these assets into cash without any great loss endows them with the required degree of liquidity.

In the last two or three years not only has the share of linked bonds in the financial assets portfolio risen at the expense of unlinked assets (including the money supply), but the liquidity of this instrument has increased (see Bank of Israel, *Annual Report 1973*, pp.345-47); as a result, bonds (or at least some of them) have become part of the economy's liquid assets portfolio, and not only part of the long-term

XVII-3

THE MONEY BASE (NARROWLY DEFINED), 1972–73

increase and [–] a decrease)

July	Aug.	Sept.	Oct.	November 1–8	November 10–29	Dec.	Total 1974	Post-devaluation
206	596	620	680	273	–318	–159	2,891	–477
–51	–21	–20	–30	–4	–28	–28	–157	–56
–512	–400	–268	–724	–329	260	83	–4,558	343
40	—	53	48	–20	45	–38	334	7
–53	–25	–164	–101	–71	657	27	–286	684
–325	–425	–379	–777	–420	962	72	–4,510	1,043
67	643	199	80	58	–75	113	1,413	38
19	168	11	1	–6	–42	–36	385	–78
164	5	–84	110	8	–19	166	564	147
–120	**966**	**347**	**64**	**–91**	**480**	**128**	**586**	**608**
77	–70	43	68	—	87	25	454	112
–12	39	68	–85	–30	28	59	82	87
–55	**935**	**458**	**47**	**–121**	**595**	**212**	**1,122**	**807**

foreign currency valuation adjustments, less (plus) net sales of foreign currency by the government and less Bank of Israel foreign currency income.

[e] The change in these balances, less (plus) foreign currency valuation adjustments; mostly Pazak and Tamam accounts.

investment portfolio.[7]

About a year and a half usually elapses before an increase in the money base and the economy's liquidity makes its full effect felt on the level of domestic demand and prices, and therefore it is virtually impossible to relate with a fair degree of accuracy the extent of the monetary expansion in a specific period to the demand for real goods and services and price movements in the same period.

Before concluding this discussion of developments in the course of the year, two

[7] Of both households and the economy as a whole, thanks to the large volume of bond redemptions.

other phenomena should be noted. One is the formidable contribution of the public sector to demand in the economy; since this sector's demand is not associated with the development of the economy's financial assets portfolio, it is hard to relate the changes in these two aggregates from the macroeconomic aspect, even if a close connection can be found in the case of the private sector. Secondly, much of the upward thrust on the price level this year stemmed not from the existence of excess demand in the economy but from the lifting of government subsidies, devaluation of the Israeli pound, and escalating world prices; however, even in such a case some monetary expansion is necessary for maintaining the volume of real activity at the new price level.

Regarding the growth of the public's financial assets portfolio and the existence of excess demand for liquid assets at the end of the year, we should again stress the increase in the proportion of linked bonds in the public's financial asset holdings in general and its liquid assets in particular, at the expense of unlinked assets, especially money—a development which makes it hard to ascertain whether there was excess demand or supply at the end of the year. In the past it was customary to observe the movement of the ratio between the money supply and the volume of business transactions in the economy measured in relation to the national product or resources available to the economy as an indicator of how demand might develop. In a period of inflationary expectations and the reshuffling of the liquid assets portfolio of households and businesses because of changing business conditions, it is hardly reasonable to assume that the ratio between the stock of money and the volume of real transactions will remain constant.[8] In fact, it is difficult to clearly determine whether there was excess demand, excess supply, or equilibrium in the liquid assets market at the end of 1974; but from data on the circulation velocity of the money supply in relation to GNP or total resources available to the economy, and especially trends in the secondary bond market, it is clear that there was no excess demand of any significant proportions.

In the early part of the year reservists began to be gradually released. Steps were taken to ensure adequate liquidity in order to ward off any monetary tightness and thereby permit the rapid restoration of normal economic activity and prevent the creation of unemployment because of a likely subsiding of private sector demand. Money was apt to become tight as the result of a huge foreign currency conversion

[8] It should be pointed out that in recent years the public has become increasingly aware of the existence of linked bonds (because of the compulsory loans and the enormous publicity given this investment instrument). The result has been a structural decrease in the ratio between the money supply and the gross national product, with spare money not required for current transactions shifting to more profitable assets.

Table XVII-4

THE MONEY BASE, BY COMPONENT, 1972–74

(IL million)

End of period	Currency in circulation	Liquid assets of banking institutions	Money base narrowly defined (1 + 2)	Liquidity exemptions	Recognized liquidity deficiencies	Money base broadly defined	
						IL m.	Percent increase
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1972	1,974	3,030	5,004	474	4	5,482	31.3
1973	2,715	3,588	6,303	614	25	6,942	26.6
1974							
January	2,655	2,740	5,395	735	35	6,165	-11.2
February	2,647	2,743	5,390	701	37	6,128	0.6
March	2,719	2,559	5,278	731	37	6,046	-1.3
April	2,738	2,697	5,435	763	34	6,232	3.1
May	2,771	2,885	5,656	839	66	6,561	5.3
June	2,776	2,339	5,115	838	40	5,993	-8.7
July	2,794	2,201	4,995	915	28	5,938	-1.0
August	2,913	3,048	5,961	845	67	6,873	15.7
September	3,038	3,270	6,308	888	135	7,331	6.7
October	3,122	3,250	6,372	956	50	7,378	0.6
November	3,113	3,648	6,761	1,043	48	7,852	6.4
December	3,173	3,716	6,889	1,068	107	8,064	2.7

following the widening of the country's adverse balance on goods and services account, and also because of expectations of a devaluation of the Israeli pound. Private sector consumption and investment were expected to slacken, with a consequent rise in unemployment until the incremental public sector demand could begin to make itself felt.

In pursuing this policy the authorities were aware that monetary expansion might also fuel a continued speculation in linked bonds, which began in the final part of 1973, and even more seriously, in foreign currency. This period witnessed repeated waves of devaluation expectations, with a consequent increase in conversions of Israeli currency through the advancing of payments and purchases abroad, the holding up of transfers of export receipts, the transfer of capital abroad wherever legally permitted,[9] and so forth.

It is against this background that the public sector liquidity injection, expansion of Bank of Israel credit (primarily through the directed credit funds), restructuring of

[9] The reference is primarily to those who transferred money to Israel in the past and were entitled to reconvert their funds within a specified period.

the funds, and plummeting of Short-Term Loan holdings should be viewed. With the continued release of reservists and the revival of private sector demand, it became clear that the foremost problem was not to ensure the full restoration of economic activity, but to combat the overheating of the economy and the accompanying high rate of inflation and dwindling of foreign exchange reserves because of the growth of the current deficit and speculative purchases of foreign currency.

In May a policy of restraining the monetary expansion was introduced (see section 3 beow). But even though a number of signs indicated that this was beginning to have the desired effect (some increase in bond yields and a rise in debitory interest rates), the liquidity injection was still too large, permitting a further spiralling of prices and speculation in foreign currency. Between April and July the money base (excluding private sector sales of foreign currency) swelled by IL 1.8 billion, and the banking institutions' liquid asset deficits reached an all-time high of IL 1,140 million at the beginning of July.

During the first six months of the year nondirected Israeli currency credit jumped 62 percent at an annual rate, and the total amount lent to the public (directed and nondirected credit in Israeli and foreign currency) expanded at a 54 percent annual rate. Some regarded this as the main factor behind the excessive pickup of economic activity and the source of financing speculation in foreign currency, and they called for counteraction. But there were others who argued that while a much slower growth of c. lit would dampen speculative transactions and the volume of conversions, it would at the same time gravely affect legitimate business activity. In support of the contention they cited the increase in labor costs, and especially the rise in raw material prices which reached unheard-of heights during this period, as well as the need to build up inventories in the face of the world shortage of raw materials. It seemed that the thorniest problem was the difficulty of selectively channelling the monetary expansion to beneficial economic activities and away from undesirable activities.

In the middle of August (after some two months of deliberation), the Bank of Israel issued a directive freezing nondirected credit for three months at the average level of the first three Wednesdays in July. This blunted the growth of such credit, and it even began to shrink (see Table XVII-11). This was accompanied by a drop in foreign currency purchases by the private sector (which was influenced by the fact that the monetary measures introduced in July made a possible devaluation a more remote matter) and the creation of a sizable excess supply in the bond market (both the volume of new issues and secondary market prices tumbled). The softening of these two markets suggests a strong connection between foreign currency and bond market developments in the first half of the year and the liquidity position of the economy (a detailed analysis of the efficacy of the credit ceiling is given in section 3).

In describing credit developments during the year two points should be noted in particular: the liquidity deficiencies run by the banking institutions and debitory interest rates. The banks' liquid asset deficits reached unparalleled dimensions, from the aspect of both duration and size. To be sure, at the beginning of the year the penalties for such deficiencies were still at the low 5 percent rate introduced after the outbreak of war in order to enable the banks to meet any sudden demand that might arise, but even at the beginning of May, when the fines were restored to normal, the deficiencies continued to swell; at the beginning of July they peaked at IL 1.1 billion, or 35 percent of the net liquidity requirements (see Table XVII-6). While the shift to linked assets depressed the balance of time deposits and arrested the growth of demand deposits, the main reason for the dramatic rise in the banks' deficiencies lay in the huge expansion of nondirected credit, which reached some IL 550 million in June alone and about IL 650 million from the restoration of the high penalty rates at the beginning of May until the end of July, when the freeze on nondirected credit went into force.

This development, which occurred at a time of rampant inflation and speculation in foreign currency and bonds, calls for a rethinking of the central bank's supervisory policy and its powers to enforce policy decisions.

The second phenomenon was connected with the movement of debitory interest rates. The complex nature of such rates makes it hard to precisely estimate their development in the course of the year. But it seems that for various reasons they lagged behind the growth of demand,[10] with a consequent widening of the gap between nominal interest rates and the general price level. This spurred speculators to finance their transactions with bank credit and created pressure on the banks to disregard the liquidity regulations. It seems that the policy of "cheap money" with respect to long-term credit operates—although less potently and for other reasons—also in the case of short-term credit. A similar but even more pronounced development took place in creditory interest rates on demand deposits and particularly time deposits (discussed below).

In the middle of August, after the banks' liquidity deficiencies reached a record high, the volume of nondirected bank credit far surpassed what was required for financing real transactions, and private sector conversions in June and July totalled some $ 140 million a month, the Bank of Israel took a number of countermeasures,

[10] In 1974 the debitory interest rate on nondirected credit was raised (even in the extreme case of borrowers who exceeded the credit ceiling) by about 7 percent only, while the general price level went up by some 30 percent during the year. As a result, the real rate of interest fell by at least 23 percent, and in most cases (which did not entail the payment of a fine) even more.

notably the freezing of nondirected credit at its level at the beginning of July, while helping the banks to extricate themselves from their deficit position (for details of these monetary measures see section 3 below).

At first it seemed that these moves were having the desired effect: the volume of nondirected credit shrank, bond prices and foreign currency purchases by the private sector slumped (the latter owing mainly to the economic measures introduced in July, when expectations of an imminent devaluation evaporated with the announcement of the new steps, which did not include a change in the external value of the IL), and the banks' liquidity deficiencies contracted sharply. But the huge liquidity injection by the government and Bank of Israel led to a renewed surge of conversions. Between August and October the government pumped in more than IL 1.9 billion,[11] and the Bank of Israel roughly IL 1.3 billion through its directed credit funds, open-market operations, and other means. Part of this injection did not have an expansionary effect during this period since, along with the freeze on directed credit, it was intended to help reduce the banking institutions' liquidity deficiencies rather than to serve as a base for monetary expansion. It should also be recalled that the Bank of Israel's injection must be viewed against the government's planned absorption in the wake of its July measures. But in actual fact the government injected some money because of the steep fall-off in bond sales. It follows that even after the measures introduced in August, the injection did not slacken. Only its sources changed: the inflow originating in the banking institutions' failure to adhere to the liquidity regulations came to an end, but on the other hand there was an increased injection by the public sector and the Bank of Israel. The outcome was a renewed growth of foreign currency purchases as well as of the money supply.

In early November the government introduced another round of economic measures, the most salient of which were the devaluation of the IL by 43 percent and the banning of the import of a number of luxury goods. The immediate impact of the devaluation on the money base was a return flow of assets that had been transferred abroad, the halting of foreign currency purchases, and a heavier conversion of foreign currency deposits or those denominated in foreign currency. Net private sector sales of foreign currency to the Bank of Israel came to $ 58 million by the end of the year, while foreign currency deposit conversions totalled IL 680 million, with the bulk of the sum being recorded in the first few weeks after the devaluation. It is a reasonable inference that most of the funds converted were invested in linked assets, as evidenced by the rise in the last two months of the year in bond prices and sales (IL 1.6 billion compared with IL 480 milion in the two preceding months). This flurry of sales explains the $ 480 million absorption by the

[11] Largely because of the reduction, or even discontinuation, of linked bond issues.

government in the postdevaluation period. Were it not for the burgeoning sales there would have been a further injection of liqudity, as developments in the first quarter of 1975 bear out.

3. The Economy's Liquidity and Monetary Policy

(a) *January-July*

As already indicated, at the beginning of the year the main object of monetary policy was to facilitate the restoration of normal economic activity by forestalling a squeeze on money due to the external drains expected in the wake of the widening balance of payments deficit on current account and the contraction of capital imports. The uncertainty as to how the economy would develop and the need to prevent monetary bottlenecks were especially strong in the first quarter of the year, and the Bank of Israel therefore adopted an expansionary monetary policy, employing a variety of instruments.

First of all, the penalty rates on the commercial banks' liquid asset deficits were not restored to their former level but were kept at a low 5 percent, even though at the end of December the overall deficiency had reached IL 280 million. In the first quarter of 1974 the banks stepped up their lending operations despite the shrinkage of their financial resources, thereby adding a further IL 600 million to the deficiency.[12] This exerted, at least in the short run, more of an expansionary monetary effect than a similar increase in the money base would have done, for the entire sum augmented the banks' liquid assets without increasing currency in circulation, a development that accompanies an expansion of the money base.

Secondly, the composition of the directed credit funds was altered, with the proportion of financing from the banks' freely loanable funds[13] being reduced in

[12] During this period time and demand deposits decreased by IL 274 million and IL 184 million respectively, causing a deficit in the banks' required liquid asset cover; however, this accounted for no more than some IL 250 million of the overall growth of the deficit.

[13] The reference is to that part of the banking institutions' resources which may be used for purchasing assets at their own discretion. It constitutes deposits in excess of the liquidity requirements, proceeds from security issues, and undistributed profits. It is used for providing nondirected credit, covering the banks' participation in the directed credit funds and credit granted out of earmarked deposits, the purchase of securities (over and above what the banks have to invest from their approved saving scheme funds), and the acquisition of premises and equipment for the banks' own use.

comparison with credit within the framework of the liquidity exemptions[14] and Bank of Israel rediscounts. This is an effective instrument for the conduct of an expansionary monetary policy, as it immediately affects the banks' free reserves without need for a period of adjustment as in the case of instruments working in a more roundabout manner.[15] At the end of January IL 180 million was injected in this way, and at the end of February a further IL 130 million.

These expansionary measures were accompanied by a government injection, in contrast to the usual seasonal absorption (the end of the fiscal year). In January the government siphoned off IL 390 million thanks to an unprecedented volume of bond sales,[16] but in February and March it pumped in over IL 400 million. This was in coordination with the Bank of Israel's expansionary policy, for there was no point in the Bank pumping in liquidity and the government draining it out, with the high interest differentials involved. This period also saw a further decline in import deposits and the plunging of Short-Term Loan holdings of the public; together with the Bank of Israel's operations in the open market, this caused the money base to swell by a further IL 280 million. In addition, a three-month time deposit framework was created and the liquidity ratios on time deposits were slashed by 5 points (this injected IL 180 million), in order to enable the banks to raise the interest rates on these deposits and also as part of the expansionary monetary policy.

To recapitulate, in the first quarter of the year the Bank of Israel pursued an expansionary monetary policy so as to ward off the inhibiting effects which a shortage of liquidity would have had on economic recovery. But the incremental liquidity and the sinking of the banking institutions into large liquidity deficiencies also permitted the financing of speculation in linked bonds and foreign currency. During this quarter debitory interest rates rose a notch owing to the buoyant demand for credit, but because of the rampant inflation the real interest on short-

[14] The reference is to that part of bank credit granted from funds originating in the reduction of the required liquid asset cover so as to provide financing for purposes authorized by the Bank of Israel. Such credit therefore essentially resembles that granted by the Bank of Israel (external infusion), and so it is included in the money base broadly defined.

[15] The effectiveness of this instrument, as it is operated in Israel in periods of liquidity injection and absorption, is not symmetrical. When the authorities wish to mop up liquidity, they generally allow the banks a fairly long transitional period, permitting them to incur a deficiency; a liquidity injection, on the other hand, is carried out at one stroke.

[16] But since the public's bond holdings grew more than this, it is not clear how absorptive an effect this had on the public's liquidity. Given the increased liquidity of linked bonds, the method of treating the funds mobilized by the government through bond issues ought to be reconsidered.

Table XVII-5

INDICATORS OF THE LIQUIDITY POSITION OF BANKING INSTITUTIONS, 1972-74

(percentages)

End of period	Required liquidity ratio on ordinary deposits	Liquidity exemptions[a]	Actual liquidity ratio on ordinary deposits	Formal liquidity ratio on ordinary deposits (2+3)	Gap between actual and required ratio (4-1)	Free reserves (IL million; surplus +, deficit -)		Free reserves as a percent of required liquid asset cover	
						End of month	Daily average for month	Gross	Net[b]
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1972	72.0	13.2	57.5	70.7	-1.3	-47	-33	-0.9	-1.1
1973	72.0	13.4	52.7	66.1	-5.9	-283	-66	-1.5	-1.8
1974									
January	72.0	17.9	38.3	56.2	-15.8	-680	-492	-11.4	-13.5
February	72.0	16.8	39.8	56.6	-15.4	-681	-746	-17.4	-21.3
March	72.0	16.3	36.7	53.0	-19.0	-895	-682	-16.5	-20.1
April	72.0	17.1	39.5	56.6	-15.4	-719	-759	-18.2	-22.3
May	72.0	18.9	43.5	62.4	-9.6	-461	-534	-12.4	-15.4
June	72.0	18.8	32.9	51.7	-20.3	-945	-767	-18.0	-22.5
July	72.0	20.5	31.1	51.6	-20.4	-934	-994	-24.2	-31.2
August	72.0	19.5	49.1	68.6	-3.4	-158	-649	-15.8	-20.2
September	72.0	20.0	47.9	67.9	-4.1	-211	-102	-2.3	-2.9
October	72.0	20.3	48.9	69.2	-2.8	-138	-144	-3.2	-4.1
November	72.0	20.5	52.2	72.7	0.7	43	-15	-0.3	-0.4
December	72.0	20.8	50.0	70.8	-1.2	-67	122	2.5	3.3

[a] Including recognized liquidity deficiencies and liquidity exemptions.
[b] The gross required liquidity less liquidity exemptions and recognized deficiencies.

term bank credit continued downward.

During this period there were two noteworthy developments. One was the conduct of an expansionary monetary policy which, by keeping the fines for liquidity deficiencies at their reduced rates, enabled the banks to step up nondirected credit at their own discretion to meet the demand. During this period, which was characterized by considerable uncertainty as to the economy's credit needs, there was probably good reason to ensure a rapid responding of supply to changes in demand. But it transpired that the banks also expanded their lending for undesirable purposes from the macroeconomic aspect. However, once this had been done, there was no possiblity of reducing credit, not even by hiking the penalty rates.

The second development may be termed a speculative cycle. The Israeli economy is sometimes marked by a repeated reshuffling of financial asset portfolios, with a

shift from money and unlinked deposits to assets linked to the consumer price index or the exchange rate, and vice versa. At the start of such a cycle the public's liquidity is not affected by the adjustment of its asset portfolio, but the banks' liquidity is reduced, with a consequent increase in their liquidity deficiencies. In such circumstances there is no valid monetary reason to reduce bank credit to the public until the deficiencies are eliminated. If the central bank puts money into the banking system in order to reduce the deficiencies, no immediate monetary expansion takes place. The problem of the speculative cycle arises mainly when the public decides to return to its original portfolio composition (for example, after realization of an expected rise in bond prices or a devaluation of the Israeli pound). At this stage—the final one in the cycle—the banks run a liquidity surplus, which in turn allows them to grant more credit, so that at the end of this process outstanding credit and deposits are on a higher level than at the start. This description assumes, of course, that the central bank is under pressure to inject liquidity quickly when the banks go into a deficiency position but experiences difficulty in reabsorbing liquidity when the public reverts to its original portfolio mix. This took place more than once in the past, but this year it was especially pronounced.

In the first quarter of the year the money base broadly defined shrank by IL 900 million, but monetary developments did not prevent the rapid restoration of normal economic activity, as borne out by developments in the real (i.e. nonfinancial) markets in the first and second quarters. Early in the year it became clear that private sector demand and economic activity in general were rebounding much faster than expected. In fact, the economy even became overheated, and this was accompanied by a disturbing speculation financed partly by the aforementioned liquidity injection. At the beginning of May the Bank of Israel therefore restored the penalty rates for liquidity deficiencies to their previous level (while cutting the banks' participation in the directed credit funds by a further IL 70 million in order to help them erase their deficits), and the Treasury reintroduced the import deposit arrangement, which not only affected the price of imports but had a restrictive monetary effect.

The hiking of the penalty rates worked in the right direction, but its effect was of limited duration. In May the volume of nondirected credit tapered off, apparently because of an increase in directed credit, and bond yields to maturity even edged up a notch—a sign of the banks' attempt to pare their deficit. This period was short-lived, and at the beginning of June, when there was a renewed wave of devaluation expectations (reflected by a rise in the Natad dollar rate from IL 4.60 in the middle of May to around IL 5.0, as well as a resumption of the uptrend in private sector conversions), the banks again began to finance such activities by greatly stepping up nondirected credit (IL 550 million in June and another IL 110 million in July). In doing this, they fell more deeply into a deficiency position, in addition to expanding

directed credit by approximately IL 300 million in June and July.

During these months the banks clearly contravened the directives of the monetary authorities. The system of controls and deterrents (i.e. the liquidity regulations and fines for failure to abide by them) obviously did not stand up to the test. The reasons apparently lay in the diminished efficacy of the penalties (which are set in nominal terms) in a period of high inflation, and the past experience of the banks, which taught them that a prolonged deficit in the system entailed in certain instances recognition of the deficit by the authorities and the injection of liquidity to eliminate it.

The money supply held steady during this period; however, as already mentioned, this was not indicative of any monetary restraint, since the aggravation of inflation led to a more economical use of money and the accumulation of other liquid assets.

At the beginning of July another round of economic measures went into force. An extra 10 percent levy was slapped on imports, a property tax was imposed on various types of assets, the War Loan was increased, new purchase taxes were introduced, and so forth. Initially this dampened expectations of a devaluation in the near future, but within two or three months they began to mount again, touching off a new flurry of speculative purchases. Again it became amply clear that when strong devaluation expectations arise at a time when there is objective need for such a step, it is better to implement it without undue delay rather than rely on foreign exchange controls to avert the undesirable developments that take place in such circumstances. During this period the interest rate on nondirected bank credit was raised, and if we recall that for three months the inflation unexpectedly slowed down, it turns out that the real rate of interest paid by borrowers was higher than they had anticipated.

(b) *August-October*

At the beginning of August the Bank of Israel decided to freeze nondirected credit for a three-month period at the average level of the first three Wednesdays in July, by clamping a 100 percent liquidity ratio on all sums in excess of this ceiling. Shortly after the introduction of this step signs appeared of some monetary contraction: bond yields moved up, new issues fell off steeply, and debitory interest rates also rose.

The volume of nondirected credit fell below the maximum throughout the entire period; conceivably this may point to the inefficacy of the ceiling (in the sense that it was set too high), and the developments described above may therefore be ascribed primarily to the expectations generated by the discussions on the imposition of the credit ceiling. These deliberations were fairly protracted, and the banks had ample

time to artificially increase their credit and thus to push up the ceiling in line with their clients' needs. Indeed, in June nondirected credit shot up IL 550 million. In such a situation the ceiling could not be expected to be effective immediately upon its imposition but only after two or three months, when the excess credit would be absorbed by the economy's mounting credit needs. But since the introduction of the ceiling was followed soon after by an enormous liquidity injection by the government and the Bank of Israel (beyond what was required for covering the commercial banks' liquidity deficiencies), this set back the date when the ceiling was supposed to become effective, and in the meantime the Israeli pound was devalued, with a resulting further injection of liquidity. This made even more remote the date when the credit ceiling could be expected to begin leaving its impress. On the other hand, it may also be that the ceiling was indeed effective, and the desire of the banks to avoid infringing it was so compelling that they allowed themselves a certain margin of safety.

Besides the credit ceiling, the Bank of Israel took other action to extricate the banking institutions from their deficiency position without reducing their lending operations to the full extent required, as this was liable to have unfavorable results. To this end it again altered the composition of the directed credit funds, thereby reducing the banks' participation from their freely loanable resources by IL 400 million. The Bank of Israel purchased IL 135 million of securities from the banks under a special optional repurchase agreement, which was tantamount to granting a loan to the banks on the same linkage terms as the bond issues. It also created a new fund for providing loans to businesses in exchange for Employers' Loan certificates—this too on the same terms as the linked bonds; the balance of credit supplied under this arrangement grew by IL 360 million by year's end.

These months witnessed an increase in credit from the various funds. Part of the increment is explained by the usual seasonal demand (citriculture) and another part by the larger rate of loan capital granted by some of the funds this year.

This injection of liquidity by the Bank of Israel (which, together with its open-market operations, came to IL 1,307 million between August and November) occurred in the face of the government's plan to siphon off liquidity under its new economic policy. But it turned out that not only did the government fail to absorb money during these months, it actually pumped in IL 2,094 million because of a shortfall in tax collections and bond issue proceeds and heavier disbursements. The outcome was a massive IL 3.4 billion total injection between August and October. This enabled the banks to whittle down their deficiencies by IL 140 million, while reducing their nondirected credit by IL 182 million, so that a third of the injection covered deficiencies incurred in the past and did not generate any new liquidity; it also helped to finance foreign currency purchases (to cover the balance of payments

deficit and the speculative demand), which during this period totalled IL 1.7 billion, of which over IL 700 million was converted in October alone.

It was against this backdrop that the government devalued the Israeli pound on November 9 by 43 percent, partially lifted its subsidies on basic commodities, and banned the import of a number of luxury goods.

(c) *The postdevaluation period*

During the seven weeks between the devaluation and the end of the year there was an improvement in the country's foreign exchange reserves. Private sector conversions came to an end and there was even a reconversion of foreign currency into Israeli currency; in addition, the public sector began to mop up liquidity from the public instead of pumping it in. On the other hand, the public converted IL 680 million of foreign currency deposits and those linked to the foreign exchange rate. The net outcome was an increase of IL 807 million in the money base broadly defined (see Table XVII-3). During this period the banks also slashed their deficiencies and there was no striking increase in the volume of credit granted (between the 9th and the end of November the level plummeted by IL 320 million, but it again turned upward in December). However, it is still difficult to distinguish between the short-term impact of the devaluation in inducing a return flow of assets which had previously been converted into foreign currency and its long-run effect on the balance of payments.

During this period the Bank of Israel took a number of measures to stave off an excessively rapid monetary expansion. On November 12 it extended the freeze on nondirected credit for an additional three months (it will be recalled that up to this time, and in fact until the end of the year, the credit ceiling did not constitute an effective constraint and the banks' credit volume fell below the ceiling), the interest charged by some of the directed credit funds was upped by 2 percentage points, the fines for liquidity deficiencies were increased by 3-4 points, the yield on the Short-Term Loan was raised, and the composition of the directed credit funds was altered, with the banks' participation being gradually scaled up by IL 124 million.

4. The Money Supply

In 1974 the money supply expanded by IL 1,330 million, or 18 percent, compared with 32.4 percent in 1973; the annual average balance went up 19.8

Table XVII-6

THE MONEY SUPPLY, 1974

(IL million)

End of period	Currency		Demand deposits		Money supply		Money supply, seasonally adjusted		Share of currency in money supply[a] (%)
	Total	Percent monthly increase	Total	Percent monthly increase	Total	Percent monthly increase	Total	Percent monthly increase	
1973 December	2,715	1.7	4,677	3.2	7,392	2.6	7,407	1.6	36.7
1974 January	2,655	-2.2	4,205	-10.1	6,860	-7.2	7,000	-5.5	38.7
February	2,647	-0.3	4,305	2.4	6,952	1.3	7,087	1.2	38.1
March	2,719	2.7	4,493	4.4	7,212	3.7	7,205	1.7	37.7
April	2,738	0.7	4,544	1.1	7,282	1.0	7,224	0.3	37.6
May	2,771	1.2	4,678	3.0	7,449	2.3	7,419	2.7	37.2
June	2,776	0.2	4,544	-2.9	7,320	-1.7	7,219	-2.7	37.9
July	2,794	0.7	4,502	-0.9	7,296	-0.3	7,245	0.4	38.3
August	2,913	4.3	4,557	1.2	7,470	2.4	7,470	3.1	39.0
September	3,038	4.3	4,918	7.9	7,956	6.6	7,854	5.1	38.2
October	3,122	2.8	4,848	-1.4	7,970	0.2	7,946	1.2	39.2
November	3,113	-0.3	5,193	7.1	8,306	4.2	8,407	5.8	37.5
December	3,173	1.9	5,549	6.8	8,722	5.0	8,740	4.0	36.3

[a] Money supply unadjusted for seasonality.
SOURCE: Bank of Israel.

percent, as against 25.3 percent in 1973 (see Table XVII-1 and XVII-6).[17] These data indicate a more modest growth of the money supply in the year reviewed, but the picture seems to be incomplete and somewhat misleading. It is important to note that in January the money supply shrank by an appreciable 7.2 percent, which was connected with the changing pattern of demand for money balances, notably a switch to linked bonds and foreign currency. In February the curve again turned upward, describing a sluggish, jagged path until August, when the rise picked up steam. Whereas between February and July the curve went up 6.3 percent, from August through December it jumped 19.5 percent, or at a 47 percent annual rate.

It is against this background that one must view the decline in the money supply in January, June, and July. In January the reversal of trend was due to the purchase of linked bonds and foreign currency on an unprecedented scale, and in the other

[17] On the last day of the year the banks artificially increased their demand deposits by about IL 300 million in order to blow up their balance sheets (see section 6b). Less this sum, the money supply grew by only 13.9 percent.

months the basic cause was the massive speculative purchase of foreign currency.

In contrast to the great volatility displayed by the various components of the liquidity injection in 1974, there was no prominent change in the marginal money supply multiplier,[18] which stood at 1.19 as against 1.23 in 1973. The lowering of the liquidity ratios on time deposits exerted an upward effect on the multiplier, while the decline in the proportion of such deposits during the year and the rise in that of currency in circulation reduced the multiplier. The net effect was, as stated, a very insignificant drop. It should be noted that in the course of the year the multiplier was higher because of the large liquidity deficiencies of the banks, but since these declined over the year as a whole, this factor tended to decrease rather than increase the multiplier.

The proportion of currency in the money supply continued upward in 1974, reaching 38 percent on an annual average as against 36.8 percent in 1973, when the downtrend of this ratio, begun in the middle of 1970, was reversed. The rise in the share of currency was influenced by the aggravation of inflation, which reduced the use of demand deposits as a store of value (i.e. for holding one's wealth) because of the increase in the opportunity cost, by the use of "black" money, the apparent diminished readiness of the public to accept checks, and so forth. The ratio between currency and demand deposits was also affected by the growth rate of the monev base—in periods of sizable external infusions a process of adjustment takes place which depresses the ratio for a time. The increase in the proportion of currency was conceivably connected with the sluggish expansion of the money base and the large volume of foreign currency conversions, which were made more from demand deposits than from cash holdings.

The variability in the proportion of currency in the money supply should occasion no surprise, for there is no reason for it to remain constant from year to year. The use of money for financing current transactions presumably ought to result in a more or less fixed ratio, but the other components of the demand for money are apt to cause the ratio to change over time. The reason for the increased preference for cash over demand deposits is not entirely clear; the consequence of this development was an internal drain, which reduced the money supply and credit multipliers.

The reversal in 1973 of the decline in the share of currency, which had persisted from 1970 to 1972, represented a return to the long-run trend. It was not connected solely with the heavier demand for cash during and immediately after the war, since the proportion of currency was on the rise in 1973 as well (from 36.3 percent in 1972 to 36.7 percent). It should be added in this context that Israeli currency serves

[18] The marginal multiplier refers to the ratio between the growth of the money supply and that of the broadly defined money base in the same period.

as legal tender also in the administered areas, but for lack of data on such holdings it is not possible to net out their effect on the movement of the currency ratio or on total currency in circulation.

Before concluding this discussion one other point should be noted. At the end of the year the public held IL 58.8 million in commemorative and special coins.[19] These constitute legal tender, but since their numismatic value is immeasurably greater than their face value, they are not treated as currency in circulation, and for purposes of economic analysis should be disregarded.

5. Other Liquid Assets of the Public

Other liquid assets of the public—IL time deposits, foreign currency deposits, Short-Term Loan, and approved saving schemes—rose in 1974 by 23 percent (excluding devaluation differentials), as against 17 percent the year before. Together with capital gains, i.e. devaluation differentials on assets linked to or denominated in foreign currency and index-linkage differentials on assets pegged to the consumer price index, the portfolio swelled 51 percent (see Table XVII-7).[20] This group of assets is very heterogeneous, and the various components did not move in the same direction during the year. The aggravation of inflation caused the public to shed unlinked assets (IL time deposits and the Short-Term Loan) to the tune of some IL 450 million, or 11 percent, while the revalued portfolio of assets linked to the consumer price index or the foreign exchange rate shot up by IL 8.1 billion, or 82 percent. The growth of the linked bond portfolio must be added in determining the full increase in the proportion of value-linked items in the public's financial assets portfolio.

(a) *Pazak and Tamam accounts*

The accumulation of foreign currency deposits and those denominated in foreign currency was influenced by numerous factors this year, of which the most important were the volume of transfers and other receipts from abroad, the capital gains accruing from foreign currency valuation adjustments, and the recurring expectations of a devaluation of the Israeli pound, which affected the volume and timing of conversions.

[19] Compared with IL 24.4 million at the end of 1973.

[20] Assuming IL 1.6 billion in index-linkage differentials on approved saving schemes and IL 3.5 billion in devaluation differentials. Obviously the various components of this asset group are not equally liquid, and this has a bearing on the degree to which they influence real activity in the economy.

Table XVII–7
OTHER LIQUID ASSETS OF THE PUBLIC, 1972–74
(IL million)

End of period	Time deposits in Israeli currency	Short-Term Loan	Total unlinked interest-bearing assets (1+2)	Approved saving schemes[a]	Deposits against liabilities	Deposits linked to and denominated in foreign currency[b]			Unrestricted and blocked accounts[d]	Grand total
						Pazak restitution	Tamam	Other[c]		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1972	3,874	711	4,585	1,779	83	2,311	1,391	969	408	11,526
1973	3,825	377	4,202	2,437	88	2,960	1,781	1,269	705	13,452
1974										
January	3,760	285	4,045	2,534	85	2,974	1,750	1,227	855	13,470
February	3,659	233	3,892	2,708	98	3,128	1,826	1,294	842	13,788
March	3,551	173	3,724	2,887	179	3,371	1,952	1,363	942	14,418
April	3,510	136	3,646	3,063	131	3,416	2,013	1,488	931	14,688
May	3,500	125	3,625	3,274	114	3,333	1,958	1,485	877	14,666
June	3,387	115	3,502	3,471	101	3,349	1,966	1,591	957	14,937
July	3,350	77	3,427	3,634	107	3,283	1,919	1,583	927	14,880
August	3,321	65	3,386	3,744	88	3,242	1,874	1,576	904	14,814
September	3,386	64	3,450	3,837	98	3,331	1,911	1,664	836	15,127
October	3,470	64	3,534	3,983	103	3,447	1,984	1,735	885	15.671
November	3,453	109	3,562	4,295	121	5,024	2,960	1,924	1,238	19,124
Devaluation differentials	—	—	—	—	—	1,477	868	779	403	3,527
December	3,601	162	3,763	4,734	108	5,177	3,138	1,879	1,314	20,113

[a] The data in this column do not include IL 2.5 billion in linkage differentials at the end of 1974. About 2 percent of the monthly balances consists of linked time deposits and the Treasury premium paid to savers, totalling IL 39 million at the end of 1973 and IL 203 million at the end of 1974.

[b] Including foreign currency valuation adjustments.

[c] Including nonrestitution Pazak accounts, Natad, diamond accounts, foreign currency deposits of mortgage banks and investment companies, and unclassified investments and deposits.

[d] Including Pamaz foreign currency accounts of banks, Hay import deposits, and blocked accounts.

Table XVII-8

ESTIMATED CONVERSION OF PAZAK AND TAMAM FUNDS BY RESTITUTION RECIPIENTS, 1972–74[a]

(IL million)

	Personal restitution	Interest on Pazak and Tamam	Exchange rate and linkage differentials	Total potential increase (1+2+3)	Actual increase	Amount converted into IL (4–5)	Rate of conversion (%) A[b] (6÷4)	Rate of conversion (%) B[c] (6/[1 + 2])
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1972	1,105	181	82	1,368	465	903	66	70
1973	1,102	238	665	2,005	1,164	841	42	63
1974	1,240	290	3,043	4,573	3,564	1,009	45[d]	66
January	86	22	–138	–30	–27	–3	–10	–3
February	78	26	191	295	230	65	22	63
March	101	28	284	413	369	44	11	34
April	98	20	138	256	106	150	59	127
May	103	23	–161	–35	–138	103	..	82
June	101	20	–102	102	24	78	76	64
July	87	16	–19	1	–113	114	..	111
August	83	16	–133	–34	–86	52	..	53
September	84	20	19	–123	126	–3	..	–3
October	103	28	157	288	189	99	34	76
November	146	26	2,607	2,779	2,553	226	451	131
December	250	45	249	544	331	213	39	72

[a] The data relate to Pazak restitution funds and Tamam, but not to other Pazak accounts.
[b] This calculation assumes that the recipients treat exchange rate differentials in the same manner as restitution receipts and interest on Pazak and Tamam accounts.
[c] This calculation assumes that the recipients treat exchange rate differentials as capital gains on the deposits.
[d] After deducting IL 2,336 million in devaluation differentials.
SOURCE: Personal restitution receipts and exchange rate and devaluation differentials — Foreign Exchange Department, Ministry of Finance: interest on Pazak and Tamam — Bank of Israel; actual increase — Bank of Israel.

The receipts and transfers under this head consist primarily of personal restitution payments and certain transfers of exporters and other Israelis. Transfers of personal restitution rose a notch, from $ 264 million in 1973 to $ 286 million. Given the further strengthening of the German mark against the dollar this year, the level was virtually stable in DM terms.

During the first ten months of the year personal restitutions, interest received on existing deposits, and exchange rate differentials added up to IL 1,380 million. Conversions into Israeli currency came to IL 699 million, or 51 percent of the total potential growth of such deposits, compared with 36 percent in 1973. Excluding

exchange rate differentials, the rate of conversions during the first ten months of the year was 61 percent, as against 71 percent 1973. Because of the difficulty of defining the rate of conversions,[21] it is hard to draw unambiguous conclusions about the behavior of the owners of such accounts during the period of devaluation expectations.

After the devaluation of the Israeli pound in early November there was some increase in conversions, the figure in the last two months of the year reaching IL 290 million (out of Pazak and Tamam accounts). Considering the enormous volume of such deposits—IL 8 billion at the end of November—the postdevaluation conversion was not large, so that the latent time bomb which these deposits represented failed to burst. The limited magnitude of the conversions was achieved without any special measures toward this end, such as the banning of conversions or the granting of incentives for nonconversion.

The development of nonrestitution Pazak accounts, Natad balances, and other foreign currency deposits reveal a different picture. During the first ten months of the year these swelled 33 percent, and after the devaluation there was a sizable conversion. In the last two months of the year their balance (less devaluation differentials) tumbled 23 percent (about IL 600 million). It seems that owners of such deposits, who differ greatly from holders of Pazak and Tamam accounts, are more sensitive to expectations of a change in the external value of the Israeli pound.

(b) *Unlinked liquid assets*

The year reviewed was the second in succcession to see a drop in the balance of time deposits and the Short-Term Loan; deposits in Israeli currency contracted by IL 224 million and Short-Term Loan holdings of the public by IL 215 million, making a total decrease of IL 439 million, or 10.5 percent.

The level did not fall at an even pace. During the first eight months it plummeted by IL 816 million, but subsequently there was some recovery, which was undoubtedly of a transitory nature (even though the yield on the Short-Term Loan was raised during this period by 1.75 percentage points).

The reference here is to the nominal size of the public's liquid assets portfolio. The sharp appreciation of its linked asset holdings, and hence of its total liquid assets, resulted in an even greater decline in the share of unlinked assets. The acceleration of inflation and the heightened expectation of a devaluation of the Israeli pound were

[21] In particular because of the difficulty of estimating the propensity to convert existing deposits, compared with the propensity to convert current receipts, interest, and exchange rate differentials.

Table

LIQUID ASSETS OF THE PUBLIC, BY

(IL

			1974			
			Monthly			
End of period	1972	1973	Jan.	Feb.	March	April
A. Sources						
Bank of Israel						
Foreign currency assets, net	4,689	7,398	-740	-49	27	-300
Credit to the govt., net	4,565	3,793	-620	248	283	506
Rediscounts						
To the Jewish Agency	415	354	-7	-12	-14	-4
To the public (incl. local and foreign currency loans)[a]	1,186	1,862	149	14	101	96
Liquidity exemptions and open-market operations[b]	-708	-400	127	48	49	20
Total	**10,147**	**13,007**	**-1,091**	**249**	**446**	**318**
Banking institutions						
Foreign currency assets, net	395	56	110	-67	-57	-127
Credit to the govt. in IL, net	894	1,222	-59	70	39	-83
Credit to the public						
Nondirected credit in IL	3,631	4,278	260	138	504	-206
Directed credit in IL (excl. rediscounts and liquidity exemptions)	891	1,102	-124	19	-137	24
Foreign currency credit to the public (excl. rediscounts and liquidity exemptions)	995	1,733	-10	-73	202	230
Total	**6,806**	**8,391**	**177**	**87**	**651**	**-162**
Other factors, net	-572	-931	492	126	-147	221
Total sources	**16,381**	**20,467**	**-422**	**462**	**950**	**377**
B. Components						
Money supply	5,587	7,392	-532	92	260	70
Less – liquid deposits in local and foreign currency[c]	10,794	13,075	110	370	690	307
Total	**16,381**	**20,467**	**-422**	**452**	**950**	**377**
Short-Term Loan held by the public[d]	711	377	-92	-52	-60	-37

[a] Excluding rediscounts for banks.
[b] Until April 1974 mainly transactions in the Short-Term Loan; thereafter mainly in linked bonds.

XVII–9

SOURCE AND COMPONENT, 1972–74

million)

change									
						November			
May	June	July	Aug.	Sept.	Oct.	Total	Devaluation differentials	Dec.	End 1974
-161	-494	-458	-465	-222	-491	2,178	1,631	205	6,428
309	-82	74	470	618	614	380	999	-98	6,495
-6	-1	-6	-11	-16	-4	109	117	-2	380
170	186	187	592	199	212	827	637	145	4,740
26	0	19	168	11	1	-48	0	-36	-15
338	**-391**	**-184**	**754**	**590**	**332**	**3,446**	**3,384**	**214**	**18,028**
-318	37	-94	-149	-70	-126	-1,145	-341	-427	-2,377
-52	-79	53	-52	80	-7	23	0	405	1,560
-3	543	107	-292	140	-30	-249	0	355	5.645
12	63	21	-323	17	7	71	85	112	864
154	-21	102	87	18	128	1,226	1,118	297	4,073
-207	**543**	**189**	**-729**	**185**	**-28**	**-74**	**862**	**742**	**9,765**
24	0	-48	95	26	254	371	-719	397	880
155	**152**	**-43**	**120**	**801**	**558**	**3,743**	**3,527**	**1,353**	**28,673**
167	-129	-24	174	486	14	336	0	416	8,722
-12	281	-19	54	315	544	3,407	3,527	937	19,951
155	**152**	**-43**	**120**	**801**	**558**	**3,743**	**3,527**	**1,353**	**28,673**
-11	-10	-38	-12	-1	0	45	0	53	162

[c] Excluding the Short-Term Loan.
[d] Excluding certificates held by banking institutions.
SOURCE: Bank of Israel.

the underlying causes of this development: since the interest rate on unlinked assets was not revised upward, it became less worthwhile to hold them. As expected, unlinked assets shrank more than the money supply, for they cannot serve as a medium of exchange to the same degree as linked assets.

In the past there was also a differential between the terms of unlinked assets and those of the various types of linked assets, but since the year reviewed witnessed both a widening of the differential and an increase in the liquidity of bonds, the relative demand for unlinked assets weakened even more noticeably. The general public, unlike sophisticated investors, tends to adjust its financial assets portfolio to a change in market conditions rather belatedly. Thus, even though the inflation began to appear as early as 1970, many individual investors' portfolios are still not of optimal composition given the new conditions.

The downtrend in the public's Short-Term Loan holdings began in September 1973, and can be attributed to the discontinuation of the commercial banks' support in selling this paper under the underwriting agreement with the Bank of Israel.[22] The public's holdings plunged from IL 735 million at the end of August 1973 to IL 65 million at the end of August 1974. At the beginning of November the net yield on the loan was raised by 1.75 percentage points in order to stimulate sales; the result was a IL 100 million growth of holdings in the last two months of the year. But the revival was short-lived, and at the beginning of 1975 the trend again turned downward. Since the Short-Term Loan is an instrument for absorbing liquidity, the dent in sales represents not only a change in the public's financial assets portfolio, but also the severe impairment of one of the monetary policy instruments.

The sagging demand for time deposits, on the other hand, has a different implication. These deposits have constituted the banks' main source of freely loanable funds, for the obligatory liquidity ratio on these accounts (26 percent) is lower than that on demand deposits or approved saving schemes. The switch from time deposits to linked bonds, or even to approved saving schemes, impairs the banks' ability to grant credit to the same extent as before. If there will be no adjustment and realignment of the debitory interest rate, the interest on liquid assets in the Bank of Israel, and the creditory interest rate on time deposits, undesirable developments may be expected in the financial intermediation function of the banking institutions.[23]

[22] See Bank of Israel, *Annual Report 1973*, p.368.

[23] The banks may find it easier on the margin to augment their funds for granting nondirected credit by incurring liquidity deficiencies than by raising the interest rate on the entire balance of time deposits, but obviously this is only a short-term solution.

(c) *Approved saving schemes*

Approved saving scheme deposits continued to expand in 1974, after the hiking of their relative yields the year before with the introduction of a new plan.[24] This savings medium became more attractive in the year reviewed for two reasons: one was the decline at the beginning of the year in the secondary market yields on linked bonds, following the worsening of the terms of new bond issues (see Chapter XIX, "The Securities Market") while the return on saving schemes remained unchanged. Today those holding their deposits for five years earn a net return of 6 percent plus linkage increments (interest is unlinked), compared with 2-3 percent on bonds bought in the secondary market and 3 percent on original issues (with the interest also linked). The second reason was the fear that linkage increments on bonds would become subject to income tax. The net increment to approved saving schemes shot up from IL 660 million in 1973 to almost IL 2 billion in the year reviewed.[25]

Most of the growth (about IL 1.7 billion) was accounted for by the new plan launched last year. It features a 10 percent premium to those holding their deposits for five years, which is equivalent to an increase of about 2 percent in the real return. On the other hand, the plan is relatively illiquid: no withdrawals can be made during the first two years, while the premium is granted only after the five-year terminal date. (It should be noted that a fairly high percentage of saving scheme deposits are broken before the end of five years.) The popularity of this savings instrument can undoubtedly be attributed to its highly profitable nature to the banks, for they are allowed to use 25 percent of the funds in the new plan for granting loans at their own discretion, compared with 15 percent for the other plans, and the banks' profit margin on these schemes is relatively large.[26] The IL 1.7 billion placed in the new plan augmented the banks' reserves by about IL 170 million, and this when they were in a liquidity deficiency position throughout most of the year. The banks made a determined effort to solicit such deposits this year in order to mitigate the negative effect which the increased share of linked assets in the public's investment portfolio had on their business volume.

[24] The maximum amount that can be deposited in this plan is IL 10,000, but there is no effective constraint on those wishing to deposit larger sums.

[25] Not counting linked time deposits and interest differentials erroneously included in the data for December (see the note to Table XVII-7 and the text below).

[26] By contrast, the percentage of deposits in this plan that are withdrawn before the terminal date is small, and this affects the banks' profits. However, the larger element of stability of such deposits probably compensates for this shortcoming; this is especially true of this period of unsteadiness in time and even demand deposits.

The vigorous expansion of approved saving schemes continued unbrokenly throughout the year, and at the end of December the balance reached IL 4.7 billion, with accrued interest and linkage increments amounting to an additional IL 2.5 billion.[27] These figures include a small sum (approximately IL 110 million) of linked time deposits in two medium-sized commercial banks. These offer an option between the going interest rate on such deposits and interest of 4-6 percent per annum, plus index-linkage increments, on sums held for at least two years. This plan seems to have an edge over alternative deposits (chiefly ordinary time deposits and approved saving schemes). Its fairly sluggish growth is indicative of the conservative attitude of the saver-investor about doing business with large banking houses and the ability of the banks to persuade their customers to place their savings in the various media; it may also be that the public's impression about the soundness of medium-sized banks in comparison with the large ones has an effect here.

6. Sources of Monetary Expansion

The statistical data on the sources of monetary expansion and its components are derived from the consolidated balance sheet of the banking system (see Table XVII-10). They cover not only the external infusions, but also the multiplier effect of money creation and credit.

(a) *Bank credit to the public*

The balance of Israeli currency credit granted to the public jumped 49 percent in 1974, with nondirected credit going up 32 percent and directed credit by 82 percent. The increase in the annual average level was 37 percent, with nondirected credit rising 30 percent and directed credit by 53 percent.

Nondirected Israeli currency credit expanded very strongly during the first seven months of the year, until the freezing of its volume at the beginning of August: the balance rose from IL 4,278 million at the end 1973 to IL 5,722 million at the end of July 1974—a 58 percent annual rate. Thereafter the curve turned downward, and by the year's end it stood at IL 5,645 million.

Directed Israeli currency credit developed differently: during the first seven months of the year the balance rose only 40 percent at an annual rate, but in the last

[27] The linkage differentials are calculated on the assumption that all the deposits will be held for their full term, and will therefore be credited with the maximum linkage differentials and rate of interest.

Table XVII–10
OUTSTANDING CREDIT GRANTED TO THE PUBLIC[a] BY THE BANKING SYSTEM (EXCL. LINKAGE DIFFERENTIALS), 1973–74
(IL million)

End of period	Non-directed commercial bank credit in IL	Directed credit in IL		Foreign currency credit through the funds		Foreign currency credit outside the funds		Total directed credit to the public		Total bank credit to the public (1+8)	Credit from earmarked nongovt. deposits	Credit against govt. deposits	Credit from earmarked govt. deposits
		Total	Rediscounts and liquidity exemptions	Total	Rediscounts and liquidity exemptions	Total	Rediscounts and liquidity exemptions	Total (2+4+6)	Rediscounts and liquidity exemptions (3+5+7)				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
1973	4,278	2,197	1,095	830	642	1,670	125	4,697	1,862	8,975	3,631	283	1,522
1974													
January	4,538	2,243	1,265	792	616	1,676	130	4,711	2,011	9,249	3,757	284	1,572
February	4,676	2,250	1,252	740	643	1,682	130	4,672	2,025	9,348	3,849	293	1,678
March	5,280	2,265	1,405	652	590	1,921	131	4,838	2,126	10,118	4,056	340	1,755
April	5,074	2,294	1,410	768	680	2,126	132	5,188	2,222	10,262	4,193	341	1,850
May	5,071	2,368	1,472	911	794	2,245	126	5,524	2,392	10,595	4,330	337	1,915
June	5,614	2,541	1,582	999	867	2,212	129	5,752	2,578	11,366	4,416	350	1,973
July	5,721	2,713	1,733	1,040	895	2,309	137	6,062	2,765	11,783	4,558	369	1,943
August	5,429	2,918	2,261	1,025	949	2,475	147	6,418	3,357	11,847	4,660	376	1,970
September	5,569	3,120	2,446	1,065	955	2,467	155	6,652	3,556	12,221	4,884	431	2,009
October	5,539	3,293	2,612	1,059	994	2,647	162	6,999	3,768	12,538	5,104	458	2,037
November	5,290	3,672	2,920	1,469	1,448	3,983	227	9,124	4,595	14,414	5,217	549	2,065
Devaluation differentials	0	239	154	451	411	1,150	72	1,840	637	1,840	0	0	0
December	5,645	3,991	3,127	1,411	1,370	4,276	243	9,678	4,740	15,323	5,431	606	2,128

[a] Excludes credit to the government and National Institutions.

five months it soared at an annual 113 percent rate.[28] This brought up its weight in total Israeli currency credit from 33.9 percent at the end of 1973 to 41.4 percent at the end of 1974. All the growth was accounted for by the various funds. Outstanding loans granted outside the funds declined this year (the stopgap credit to ensure normal economic activity during the national emergency and for financing export shipments was totally discontinued, while the sums lent from approved saving scheme deposits and within the framework of liquidity exemptions outside these funds increased).

Two new funds were launched this year: (1) An Employers' Loan Fund (90 percent rediscounts and 10 percent liquidity exemptions), set up to help industrial concerns pinched for cash by granting them loans carrying the same terms as the Employers' Loan. During the six months of its operation this fund provided IL 360 million. (2) A fund for financing the purchase of trucks, designed to facilitate the rapid expansion of the truck fleet in the light of the lessons learned during the national emergency. The size of this fund also reached IL 360 million during its seven months of operation.

The balance of credit granted by the veteran funds rose 49 percent in 1974 to reach IL 1,080 million, mainly because of the aggravation of inflation: to finance the same volume of real activity necessitated a larger volume of credit (for a detailed description of the development of the various credit funds see Chapter XX, "Activities of the Bank of Israel").

The balance of foreign currency credit to the public (all of which is directed credit) shot up 128 percent to IL 3.2 billion; less 1.6 billion in devaluation differentials, the increase was IL 1,586 million, or 63 percent. The amount supplied through the export funds expanded by only some IL 100 million, while the remaining IL 1,450 million was granted outside the funds. The latter consisted mainly of foreign currency credit extended by the banks on the strength of permits issued by the Bank of Israel and the Foreign Exchange Department of the Treasury; most of it went to shipping and fuel companies and for financing imports on consignation terms, with the borrowers generally being insured against a possible change in the exchange rate. If this type of credit had been given to individuals and businesses for financing current operations, its monetary effect would have been identical to that of nondirected and directed Israeli currency credit. Since the lion's

[28] This pattern is partly influenced by the seasonal utilization of directed export credit, particularly that granted to citriculture, which requires financing mainly during the first nine months of the year and repays it in the final quarter. There was a special factor at work in the year reviewed, namely the repayment of the stopgap credits provided during the period of fighting and national emergency.

share of such financing is generally given for special purposes (the import and buildup of fuel stocks or other transactions which do not affect normal business activity), these two types of credit should not be combined for purposes of analyzing the current business situation, but they should be aggregated for analyzing the effect of credit on the balance of payments deficit and the economy's liquidity.

To sum up, the total amount of bank credit granted to the economy, excluding the government, in both Israeli and foreign currency expanded by IL 6,350 million (70.7 percent) during the year, and excluding devaluation differentials, by IL 4,508 million (50.2 percent). In addition, the banking institutions served as a conduit for the supply of financial institution and government credit (mostly long-term) to the tune of IL 2,730 million net (an increase of about 50 percent in deposits earmarked for loans). This type of transaction is generally regarded as the sale of banking services and not financial intermediation in the usual sense, for the mobilization of the funds and decisions about their allocation are entirely in the hands of the deposit owners. However, doubts have arisen recently about the validity of this assumption with respect to several transactions of this type.

(b) *Credit to the government*

In 1974 the amount of liquidity injected by the government reached an all-time high of IL 2.9 billion, as contrasted with IL 460 million in 1973. At the same time, the Bank of Israel lent the government IL 1,703 million and the commercial banks an additional IL 340 million net. The government actually borrowed only IL 40 million (see below), so that total Israeli currency credit supplied by the banking system to the government came to IL 1,750 million.

The effect of the government's operations on the economy's liquidity (injection or absorption) is defined in this chapter as credit received from the Bank of Israel, plus sales of foreign currency by the public sector.[29] This tells how much was injected in Israeli currency by the public sector's operations, but it does not of course reflect the influence of the government's operations on the balance of payments.

This year the government's liquidity injection surpassed Bank of Israel credit by approximately IL 1.2 billion. It follows that the government sold foreign currency to the Bank of Israel in this amount and used the proceeds to finance transactions in local currency.

The government's liquidity injection did not proceed at an even pace over the

[29] Excluding interest paid to the Bank of Israel and the transfer of the Bank's profits to the Treasury.

Table XVII-11

OUTSTANDING CREDIT GRANTED TO THE GOVERNMENT BY THE BANKING SYSTEM, 1972-74

(IL million)

	From the Bank of Israel			From banking institutions			
	Credit granted to the govt.	Increase in govt. and National Institution deposits[a]	Net total (1-2)	Credit granted to the govt.	Investment in govt. securities[b]	Increase in govt. deposits[c]	Net total (4+5-6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1972	5,203	638	4,565	264	678	48	894
1973	5,664	1,871	3,793	486	823	87	1,222
1974							
January	4,843	1,670	3,173	386	866	89	1,163
February	4,947	1,526	3,421	432	891	90	1,233
March	4,906	1,202	3,704	430	932	90	1,272
April	5,338	1,128	4,210	438	846	95	1,189
May	5,016	497	4,519	442	816	121	1,137
June	4,859	422	4,437	435	774	151	1,058
July	4,939	428	4,511	438	782	109	1,111
August	5,288	307	4,981	419	758	118	1,059
September	5,855	256	5,599	420	817	98	1,139
October	6,494	281	6,213	428	830	126	1,132
November	7,514	921	6,593	446	835	126	1,155
Devaluation differentials	1,011	12	999	0	0	0	0
December	6,952	457	6,495	750	988	178	1,560

[a] Includes the capital of the Bank of Israel and the "other accounts" item in its balance sheet.
[b] Excludes treasury bills and the banks' Short-Term Loan holdings.
[c] Israeli currency deposits, the government's participation in the working capital funds, and the difference between government deposits earmarked for loans to the public and the loans actually extended.

year, but it pumped in money throughout the first ten months, including the final quarter of the fiscal year (January-March), which generally witnesses a seasonal absorption of liquidity because of a surge in government revenue. To be sure, in January the government absorbed IL 387 million, but this stemmed solely from the sale of bonds to the public; while this reduced the government's liquidity injection as conventionally measured by the full amount of the net proceeds, it certainly did not reduce the liquidity of the bond purchasers to the same extent. Therefore, it can

hardly be said that this represented an absorption in the economic sense, even though from the accounting viewpoint it did reduce the government's injection.

Bank credit to the government mainly takes the form of purchases of approved securities with saving scheme monies; as a rule credit to the government does not come under the head of "directed" or "nondirected". In Table XVII-11 there is another item of credit to the government, consisting mostly of obligatory deposits (principally compulsory loans). On the final day of the year the banks credited civil servants' accounts with some IL 300 million on account of their salaries, thus placing credit in this amount at the government's disposal. No significance is to be attached to this, however, since next day the government deposited the funds for the payrolls, and the entry was cancelled; this was mere window-dressing of the banks' balance sheets.

(c) *Influence of foreign currency assets*

In 1974 net foreign currency assets of the Bank of Israel shrank by $ 690 million. During the first ten months of the year they dropped by some $ 880 million, rising in the last two postdevaluation months by $ 110 million, a trend that carried over through the first part of 1975 (see Table XVII-12).[30] At the end of the year reviewed the Bank's holdings totalled $ 1,701 million. The $ 690 million decrease was the resultant of a $ 1,220 million net purchase of foreign currency by the private sector, which was partly offset by $ 250 million of profits from the management of foreign currency reserves and other transactions and $ 280 million in government transfers. Private sector purchases of foreign currency were an important factor this year. Part of these purchases financed the balance of payments deficit on current account stemming from the advance in world prices and the real deficit not covered by capital imports, while another part was connected with the speculative purchase of commodities and foreign currency transfers abroad in anticipation of a devaluation. It should be noted that not all the private sector's transfers for financing the balance of payments deficit derived from the growth of private consumption: a not insignificant share constituted an indirect import for the public sector in general and the defense establishment in particular.

Net foreign currency balances of the banking institutions tumbled IL 2,433 million during the year to stand at -IL 2,377 million. The reference is not to outstanding foreign currency items in the institutions' balance sheet, but their net claims on the foreign sector. The main difference between the two concepts is that

[30] In this table the data are given in Israeli currency terms in order to render them comparable with the data in Table XVII-9.

Table XVII-12

FOREIGN CURRENCY ASSETS AND LIABILITIES OF THE BANKING SYSTEM,[a] 1972-74

(IL million)

	Bank of Israel				Banking institutions			
		Foreign currency liabilities				Foreign currency liabilities		
End of period	Foreign currency assets (1)	Patach deposits[b] (2)	Other liabilities[c] (3)	Net assets (1–2–3) (4)	Foreign currency assets[d] (5)	Non-residents' deposits[e] (6)	Other liabilities[f] (7)	Net assets (5–6–7) (8)
1972	5,717	657	373	4,687	5,379	2,169	2,815	395
1973	8,099	473	228	7,398	7,117	3.242	3,819	56
1974								
January	7,341	463	220	6,658	6,410	3,375	2,869	166
February	7,275	446	220	6,609	6,306	3,553	2,654	99
March	7,320	477	207	6,636	6,900	3,512	3,346	42
April	7,193	487	370	6,336	6,363	3,608	2,840	-85
May	7,078	509	394	6,175	5,767	3,586	2,584	-403
June	6,555	463	411	5,681	6,537	3,673	3,230	-366
July	6,080	450	407	5,223	5,939	3,837	2,562	-460
August	5,601	469	374	4,758	5,873	3,898	2,584	-609
September	5,410	487	387	4,536	5,914	3,913	2,680	-679
October	4,985	512	428	4,045	6,889	4,026	3,668	-805
November	7,761	772	766	6,223	9,740	5,650	6,040	-1,950
Devaluation differentials	2,033	228	174	1,631	2,968	1,734	1,575	-341
December	7,980	775	777	6,428	10,227	5,589	7,015	-2,377

[a] Including differentials arising from the change in the exchange rate of the dollar against other currencies.
[b] Nonresidents' deposits redeposited by the banking institutions with the Bank of Israel.
[c] Including deposits of foreign banks and Israeli currency deposits of the International Monetary Fund in connection with drawings on the first and second credit tranches and the IMF allocation of Special Drawing Rights.
[d] Loans to and deposits with foreign banks and overseas branches of Israeli banks, loans to nonresidents, foreign securities, and vault cash.
[e] Including deposits of new immigrants and temporary residents, less Patach deposits redeposited with the Bank of Israel.
[f] Deposits of foreign banks and overseas branches of Israeli banks.

foreign currency credit granted to the local economy, including the government, is excluded from the second concept but not the first. At the end of 1973 net foreign currency assets amounted to IL 56 million, but since in the year reviewed the banking system lent heavily to domestic borrowers, this pulled down the balance to -IL 2,377 million (-$ 396 million) by the end of the year.

In 1974 the combined balance sheet of the banking institutions from domestic operations expanded by 65 percent to stand at IL 82.5 billion; of this, IL 39 billion was in Israeli currency (excluding devaluation differentials). Devaluation differentials came to IL 9.2 billion, and foreign currency assets to IL 34.3 billion (see Table XVII-13).

The main sources of the IL 10.6 billion growth of Israeli currency assets (excluding devaluation differentials) were deposits earmarked for loan purposes (up about IL 5 billion), approved saving schemes (IL 2.3 billion), and demand deposits (IL 900 million); the balance of time deposits, on the other hand, declined by approximately IL 200 million.

As already noted, devaluation differentials totalled IL 9.2 billion at the end of the year. Since the data for the end of 1973 are downward-biased because of the nonstandardized form of reporting by some of the banks, no significance should be attributed to the rate of growth in 1974.

Foreign currency assets swelled 97 percent during the year; less revaluation increments due to the devaluation of the IL in November, the increase was only 24 percent, stemming from the receipt of new deposits and foreign currency valuation adjustments. In foreign currency transactions there was a striking expansion of deposits from abroad, by both private individuals and banks, reflecting the greater resort this year to foreign currency credit (see the growth of directed foreign currency credit and loans to the government), as well as the increase in Pazak and Tamam deposits, which were not converted to any sizable extent even after the devaluation of the Israeli pound.

A comparison of the banking institutions' foreign currency assets with their foreign currency liabilities shows that the latter were more than covered. On the other hand, the data on accumulated index-linkage differentials cannot indicate the accrued balance of such differentials, mainly because they represent accumulated unrealized revaluation increments, and not the balance of assets linked to the consumer price index.

Table XVII–13

ASSETS AND LIABILITIES OF BANKING INSTITUTIONS, 1973–74[a]

(IL million)

End of period	1973				1974			
	Israeli currency	Index-linkage differentials[b]	Foreign currency	Total	Israeli currency	Index-linkage differentials	Foreign currency	Total
Assets								
Liquid IL assets at the Bank of Israel[c]	3,589	—	—		3,716	—	—	
Foreign currency deposits with the Bank of Israel[d]	—	—	6,030		—	—	10,333	
Loans and deposits abroad	—	—	6,117		—	—	10,227	
Nondirected credit	4,278	118	—		5,645	299	—	
Participation in directed credit	1,693	15	1,756		1,891	59	4,115	
Credit to the public from earmarked deposits	3,631	978	—		5,431	2,714	—	
Credit to the public from govt. deposits	1,805	7	—		2,734	38	—	
Securities of Israeli companies and institutions	1,769	17	21		3,423	1,474	34	
Premises and equipment	379	—	—		569	—	—	
Loans to the govt. from the banks' own means	539	43	269		799	265	350	
Government bonds[e]	866	49	—		989	608	—	
Loans to the govt. from earmarked deposits	3,796	546	92		6,056	3,518	1,265	
Balances in transit and deposits in banking institutions	293	30	465		490	124	807	
Other accounts	2,678	—	210		2,315	30	404	
Sundry accounts[f]	1,411[g]	—	1,400[h]		2,284[g]	19[g]	2,514[h]	
Contingent accounts[i]	1,683	9	2,515		2,719	58	4,202	
Total assets[j]	**28,410**	**1,812**	**19,875**	**50,097**	**39,066**	**9,206**	**34,251**	**82,523**

Liabilities

Equity capital and capital notes	1,274	—	121		1,955	—	176	
Foreign deposits[d]	—	—	7,015		—	—	12,576	
Rediscounts	135	1	—		194	4	—	
Demand deposits	4,677	—	—		5,549	—	—	
Time deposits	3,825	13	—		3,601	41	—	
Approved saving schemes	2,436	59	—		4,735	2,506	—	
Foreign currency deposits of the public	—	—	6,725		—	—	11,506	
Approved earmarked deposits	7,319	1,683	70		11,224	6,618	79	
Earmarked govt. deposits[k]	1,818	9	33		2,831	13	38	
Government accounts[l]	139	1	1,085		227	2	1,111	
Banking institution deposits and balances in transit	518	45	369		721	161	786	
Other accounts	3,338	29	230		3,157	30	781	
Sundry accounts[f]	1,523[m]	—	1,400[h]		2,389[m]	19[m]	2,514[h]	
Contingent accounts[i]	1,683	9	2,515		2,719	58	4,202	
Total liabilities[j]	**28,685**	**1,849**	**19,563**	**50,097**	**39,302**	**9,452**	**33,769**	**82,523**

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[a] A new series; the balance sheet published by the Department of the Examiner of Banks has been adjusted to conform to the definitions in this chapter.

[b] Linkage differentials for 1973 are underestimated, mainly in the case of savings and investment in securities, because of the absence of a standard form of reporting.

[c] IL deposits with the Bank of Israel treated as a liquid asset, treasury bills, and vault cash.

[d] Deposits of nonresidents, new immigrants, and temporary residents, less deposits with the Bank of Israel and deposits of foreign banks and overseas branches of Israeli banks.

[e] Including the Short-Term Loan.

[f] Includes all the adjustments mentioned in note [a].

[g] IL rediscounts for the public (before deducting deposits).

[h] Foreign currency rediscounts for the public (before deducting deposits), rediscounts for the Jewish Agency, and Patach funds deposited with the Bank of Israel.

[i] Acceptances, guarantees, and documentary credits.

[j] The breakdown of the total differs from that in the balance sheet published by the Department of the Examiner of Banks, since in this table rediscounts and credit to the public in the Export Shipments Fund are treated as Israeli currency credit, and deposits in the import funds are treated as foreign currency deposits.

[k] Utilized earmarked deposits.

[l] Including demand, time, and unutilized earmarked government deposits.

[m] As in note [g], plus deposits against liabilities and demand deposits of the public in the Israel Bank of Agriculture.