

CHAPTER XVIII

THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET^{1,2}

I. OVERALL ANALYSIS

1. MAIN DEVELOPMENTS

The resources available to the system of financial intermediaries surveyed here for onlending to the productive and service sectors of the economy, households, and local authorities expanded by a respectable 53 percent in 1974 to reach IL 5.5 billion (after deducting a IL 1.7 billion net liquidity injection to the government and banking institutions—see Table XVIII-1). While this enabled the institutions to step up their total medium- and long-term credit to about the same extent as in 1973 in real terms (6 percent),³ there was a drastic change in the distribution of such financing: a sizable decrease in the amount granted to the productive and service sectors (notably industry), and a record increase in that supplied to households.

¹ The institutional structure of the capital market is defined here as the system of financial intermediaries engaged primarily in the mobilization of medium- and long-term funds for investment in financial assets, such as loans and securities. Included in this definition are banks providing development loans to various sectors, mortgage banks, investment companies of various financial concerns, household finance companies, and such primary financial intermediaries as provident and pension funds, insurance companies, and mutual funds, as well as saving schemes and deposits for loan purposes administered by commercial banks separately from their monetary financial intermediation (the creation of money and granting of short-term credit). Excluded from this system are institutions financed by a limited number of proprietors and holding companies, the bulk of whose investment is in subsidiaries. This chapter therefore covers all institutional nonmonetary financial intermediation, apart from direct government operations in the capital market (such as the direct financing of local authorities, collection of compulsory loans from households and business, and so forth); these operations will be incorporated in the structure in the future.

² Because of the change in the presentation of the statistical and conceptual framework this year the reader is referred to sections 2 and 3, which explain the methodology used here.

³ 49 percent in nominal terms (see Table XVIII-5).

As in the past, household savings and those of the private sector as a whole were the leading source of funds. The sum provided this year expanded enormously, so that this source maintained its dominant position, even though total and financial voluntary private savings grew much more sluggishly than in 1973. At the same time there was a conspicuous structural change in financial savings funneled by households to the intermediaries. Along with an impressive 150 percent jump in savings through social insurance funds, insurance companies, approved saving schemes, and mutual funds, households shed a large portion of their direct investment in securities. As a result, whereas in 1973 households and business together contributed IL 857 million to the system's resources through the net purchase of securities, in 1974 there was a IL 596 million flow in the opposite direction.⁴

This shift from a fairly liquid financial saving (bonds) to a much less liquid one (through the system of intermediaries surveyed here) was not accompanied by any significant increase in the relative yield of the latter. It can apparently be ascribed to the rumors circulating about the possible taxing of bond linkage increments. The behavior of the household sector is probably explained by the belief, and/or the advice of financial concerns, that this form of saving would ultimately fare better than a direct investment in securities. Other contributory factors were undoubtedly the determined opposition of the financial intermediaries to the impairment of saving through this medium, and their reluctance to vigorously resist the unfavorable change in the terms of bond issues sold to the general public.

Despite the much larger supply of funds to the system in 1974, its net credit outflow to the government expanded by a sluggish 18 percent. This probably did not stem from any reduction of the government's share in the institutions' bond issue proceeds, but reflected a hefty increase in its linked debt repayments and a fairly slow growth of its income from unlinked assets held with the institutions. The aggravation of inflation in the year reviewed led to a heavier rolling of debts by the public sector, with all its attendant budgetary difficulties.

In contrast to the laggard increase in the government's net absorption from the intermediaries, their net flow to the banking institutions went up by a fairly steep IL 210 million to reach IL 350 million. This was probably connected with the tight liquidity situation of the commercial banks throughout most of the year.

While the total amount of financing provided by the intermediaries rose to about the same extent as in 1973 in real terms (6-7 percent), its composition underwent a drastic change. There was a significant increase in the already high proportion of

⁴ This also applies to total direct security transactions (including net purchases of government bonds) of households and business—net sales of IL 322 million in 1974, against a IL 1,433 million net purchase in 1973.

Table XVIII-1

**SOURCES AND USES OF MEDIUM- AND LONG-TERM FUNDS — CAPITAL
MARKET INTERMEDIARIES,^a 1973-74**

(IL million)

Sources	1973	1974	Uses	1973	1974
Household savings, net of withdrawals	1,850.2	4,586.4	Gross medium- and long-term credit to:		
Business deposits and sale of securities ^b (net)	174.9	397.2	Households	1,079.5	1,886.4
Net receipts from household and business security transactions	856.7	-595.7	Agriculture	386.6	504.7
Total	2,881.8	4,387.9	Industry	823.4	944.0
Loan repayments from:			Construction	240.7	344.4
Households	602.1	740.9	Services	170.7	253.4
Business	967.3	1,363.0	Local authorities	459.2	784.3
Local authorities	300.2	591.7	Total	3,160.1	4,717.2
Subtotal	1,869.6	2,695.6	Net transfers to:		
National Institutions (net)	83.0	130.7	Government	1,144.1	1,353.0
Rest of the world (net)	39.9	18.9	Banking institutions	134.8	346.9
Unknown	28.5	20.8	Total	1,278.9	1,699.9
Subtotal	151.4	170.4	Short-term uses, net ^c	30.9	354.6
Total sources	4,902.8	7,253.9	Surplus of expenditure over income	380.9	449.9
			Dividends	161.2	261.6
			Other payments, net ^d	-272.6	-199.0
			Change in cash balances and demand deposits	163.4	-30.3
			Total uses	4,902.8	7,253.9

NOTE: Receipts and payments on account of medium- and long-term debt repayment, savings withdrawals, and redemption of securities include not only the principal (as in the past) but also interest and linkage increments paid. In the flow-of-funds system these components were previously defined as real (i.e. nonfinancial) transactions and included in the surplus of income over expenditure. In the present system the "surplus of expenditure over income" includes, in addition to payroll, service charges, purchase of real assets, etc., only interest received and paid on short-term credit transactions.

^a As defined in note 1 in the text. The sources and uses are presented on a cash basis.

^b See the detailed explanation in section 2.

^c The increase in outstanding short-term assets, less the increase in outstanding short-term liabilities (does not include short-term items in connection with allocations to reserves and other bookkeeping entries).

^d Taxes, general insurance premium and claims payments, and receipts and payments in connection with reinsurance.

subsidized credit, which in 1974 constituted the lion's share of the financing granted to home buyers and to agriculture and industry. Another major change was the sharp drop in the share of investment financing supplied to the various productive and service sectors (especially industry); on the other hand, the proportion of loans to households and local authorities increased. These changes were more or less in line with those in the real sphere. The slackening of the uptrend in capital spending this year led to a sluggish growth in the amount of directed credit for this purpose (the

supply of which is generally proportional to the volume of nominal investment)⁵ and to a diminished demand for linked nondirected credit. The cloudy business outlook induced a greater risk aversion and a cautious, selective attitude toward investment in general. This in itself brought up the percentage of the (reduced) planned investment financed from own sources and resulted in a smaller resort to nondirected credit, which became much dearer in 1974 because of the aggravation of inflation. This applies in particular to industry, gross lending to which was stepped up only 15 percent, depressing the ratio of such financing to total investment from about 50 percent in previous years to 43 percent. According to various indicators, it seems that the more laggard expansion of industrial capital spending was accompanied by some change in its composition, both geographically (to the detriment of the development areas) and with respect to economic destination (in favor of export industries).

As regards agriculture, although its gross borrowing trailed behind the expansion of nominal investment, the volume of medium- and long-term credit received still covered 92 percent of total capital formation.⁶

Gross medium- and long-term financing supplied to households shot up 75 percent this year, surpassing the growth rates for all other types of credit. The lagging of disposable income behind the advance in the consumer price index in general and housing prices in particular generated a very brisk demand for subsidized mortgage credit (granted on easy repayment terms). The government's response to this demand was apparently on an unprecedented scale. The fact that most types of household credit linked indirectly to the cost-of-living index⁷ also rose precipitously is evidence that home buyers were pinched for funds this year.

Medium- and long-term lending to local authorities in 1974 spurred 71 percent, greatly eclipsing the growth of their capital spending at current prices. Together with directed credit from the public sector, the amount received by the authorities probably exceeded their investment outlays. Part of the funding was intended to enable them to roll debts. Because of the high rate of inflation this year, the authorities' debt repayment burden swelled from some IL 300 million in 1973 to IL 590 million.

⁵ The criteria governing the rate of financing to which preferred activities are entitled were not made tougher in 1974, nor did there seem to be any more stringent application of these criteria in practice.

⁶ Excluding land reclamation and conservation, afforestation, and drainage, which are primarily public sector investments.

⁷ In these types of credit the recipient forgoes linkage of a corresponding amount of his savings during the period of the loan.

While the intermediaries surveyed here engage predominantly in the provision of funds for medium and long periods, they also supply some short-term credit. The balance of the latter, which is fairly modest in size, is subject to sharp fluctuations dictated by the money market situation. In 1974 the inordinately heavy demand pressure caused the outstanding balance of such credit to rocket from IL 31 million the year before to IL 354 million (see Table XVIII-6).

To sum up, the institutions' gross fund-flows totalled some IL 18.5 billion in 1974 (see Table XVIII-2). Of this, one-third was within the system itself and another third with the government and banking institutions. This undoubtedly testifies to the overcomplex nature of the capital market transactions of the institutions, a situation that leaves much to be desired.

Table XVIII-2
CAPITAL MARKET TRANSACTIONS^a OF THE SYSTEM, 1973-74
(IL million)

Receipts	1973	1974	Payments	1973	1974
Deposits, loans, and sale of securities	5,065.3	6,974.9	Deposits, loans, and purchase of securities	6,812.7	10,037.1
Receipts o/a assets (deposits, loans, and securities) ^b	3,431.4	5,506.4	Payments o/a liabilities (deposits, loans, and securities) ^b	1,220.2	1,607.4
Subtotal	8,496.7	12,481.3	Subtotal	8,032.9	11,644.5
Intrasystem transactions	3,424.8	6,003.8	Intrasystem transactions	3,424.8	6,003.9
Total	11,921.5	18,485.1	Total	11,457.7	17,648.4

^a Medium- and long-term financial transactions.

^b Including interest and linkage differentials received and paid.

2. STATISTICAL-ANALYTIC FRAMEWORK

The flow-of-funds system presented in this chapter is a new statistical framework whose object is as follows:

(a) To describe the composition and magnitude of the funds made available to the intermediaries for financing the various producing and consuming sectors.

(b) To trace the primary sources of the funds which enable the system to transact its business.⁸

⁸ As distinguished from the financial resources transferred from one segment of the system to another.

(c) To delineate the flows between the various segments of the system of intermediaries, which are analyzed in detail in the relevant chapters in this Report.

The data for this chapter were obtained by means of a new form of statistical reporting for the various segments of the system, based on their operating budgets (which deal solely with actual fund-flows⁹). The format was adapted to the specific character of each category of nonmonetary financial intermediation, as well as to the limitations of the structure of accounts of each category. At the same time it was designed to meet the basic need of aggregation of data, without which it would be impossible to present an integrated statistical picture of the system's capital market operations (without double-counting or undercalculating the flows).

In these operating budgets flows arising from the receipt and supply of medium- and long-term funds are separated from those connected with short-term financial transactions. Most of the intermediaries' business is in medium- and long-term financial intermediation, with a small but not insignificant percentage being for short periods; this implies the use of capital market funds for financing money market transactions, and vice versa.

Medium- and long-term transactions appear in the operating budgets as gross fund-flows, while flows arising from the repayment (to, within, and outside the system) of medium- and long-term obligations also include interest and linkage differentials received and paid in connection with these obligations. The intermediaries' short-term transactions in the money market, on the other hand, are represented in the operating budgets as net changes in outstanding assets and liabilities. All imputations (linkage increments and the like), as well as all allocations to reserves, which appear in financial reports but do not involve an actual flow of funds, are not included in our data.

Schematically, the operating budgets, which constitute the raw material for the set of data presented in this chapter, are structured as follows:

- | | |
|--|--|
| a. Receipts from capital market transactions | a. Payments in connection with capital market transactions |
| 1. Gross inflows from loans, deposits, and sales of securities | 1. Gross outflows of loans, deposits, and purchases of original-issue securities |
| 2. Gross inflows from repayments (principal plus interest and linkage increments) on account of outstanding assets | 2. Gross outflows of repayments (principal plus interest and linkage increments) on account of liabilities (loans, deposits, and |

⁹ As distinguished from revaluations, allocations to reserves, and so forth, which do not involve actual flows of funds.

- | | |
|---|--|
| <p>(loans, deposits, and securities)</p> <p>3. Sale of securities in the secondary market</p> <p>b. Income from the sale of services and real assets (including interest received on short-term-credit transactions)</p> <p>c. Net change in short-term liabilities (balance sheet items)</p> | <p>securities issued</p> <p>3. Purchase of securities in the secondary market</p> <p>b. Expenditure on services (payroll, etc.) and real assets (including interest paid on short-term credit transactions)</p> <p>c. Net change in short-term assets (balance sheet items)</p> <p>d. Net change in cash and demand deposits</p> |
|---|--|

This is essentially a closed system of accounts, with no residual items.

The operating budgets are so constructed as to present separately the gross flows accompanying each class of medium- and long-term financial intermediation (in loans, deposits, and securities). This system of fund-flows distinguishes eight sectors: central government, local authorities, National Institutions, rest of the world, households, business, the banking system, and the "general public".

The business sector comprises producers of goods and services in agriculture, industry, construction, and the various services. In contrast to the past, at this stage no differentiation is made between private companies, public sector companies, and nonprofit institutions.

The banking system is defined here much more narrowly than in previous years. Since nongovernmental deposits for loan purposes and approved saving schemes administered by the commercial banks constitute part of the transactions of the intermediaries covered in this chapter, the fund-flows connected with these activities are not categorized as part of the banking system. Consequently, the flows between the intermediaries and the banking system is to an unspecified destination, at least as far as the individual component items are concerned (e.g. earmarked loan deposits). Much of this is transferred back to the secondary financial intermediaries, while another (relatively small) part is not identified. The latter may conceivably augment the banks' medium- and long-term funds used for financing short-term money market transactions or for some other purpose (not identified at this stage of integrating the capital market transactions).

Past *Annual Reports* did not distinguish a sector called the "general public" Under this head are lumped those fund-flows arising from the institutions' security transactions whose sectoral destination cannot be directly pinpointed. These consist of (a) the institutions' receipts and payments in connection with the purchase and sale of securities in the secondary market; and (b) that part of their issue proceeds and redemptions where the purchaser and/or redeemer cannot be directly identified.

These unidentified sums do not create a serious problem, for by far the greater part of the system's issue receipts and redemptions represents flows among the intermediaries themselves (social insurance funds, approved saving schemes, etc.), and they have been identified as regards the purchasing (and/or redeeming) sector and classified accordingly. The same applies to such transactions with the government and the rest of the world. In addition, it is hardly likely that purchases and redemptions of original-issue securities of the intermediaries and secondary market transactions therein other than by households and business (i.e. by the local authorities, National Institutions, and the banking system as narrowly defined here) come to any significant sum. We can therefore quite safely assume that the net increase in the system's resources from the "general public" originates overwhelmingly in the business and household sectors (through their direct transactions in the securities market).

From the above description of the conceptual basis for collecting and organizing the data used here, it is obvious that we are equipped with an analytical tool differing from that available in the past, when the flow-of-funds system of accounts was constructed according to the net changes in asset and liability items. The present system clearly shows the connection between the changes in the various capital market fund-flows and those in domestic saving and investment, thereby enabling us to better comprehend the financial processes associated with the changes in these two aggregates. We shall elaborate on several major aspects, emphasizing the disparate analytical possibilities in comparison with those offered by the flow-of-funds system used in the past, which was more appropriate for analyzing changes in the economy's financial assets portfolio than for gaining a better understanding of current economic trends.

(a) The system used here deals with gross flows, distinguishing between those arising from past decisions and transactions (debt repayment) and those connected directly with current decisions of producers and consumers. If we assume that in the entire economy only one person obtained new loans and repaid old ones, we could analyze current developments on the strength of the net flows. But this of course is not the case: those making investments or repaying debts in a given year are not the same as those who invested or repaid debts in the past. As regards households, those receiving loans in a particular year may be regarded as consumers who finance their consumption or part of their investment in housing in this manner, whereas those repaying debts should be regarded as savers. In this case too, constructing a flow-of-funds set of accounts according to the changes in net flows blurs the picture and makes it hard to analyze the part played by financial developments, their underlying causes and components, in attempting to explain the changes in investment and saving in the economy.

(b) The system here includes flows of funds arising from the repayment of debts (principal as well as interest and linkage differentials) in connection with medium- and long-term financial intermediation. Hence the definition of "real transactions" is much narrower than that customary in the past, and this in order to more fully describe the flow of funds between the various units in the system. To illustrate the significance of this, it should be noted, for example, that in our system current household financial saving—through provident and pension funds, saving schemes, and so forth—is not measured, as before, by the changes in total household claims (either with or without revaluation), but is calculated as the difference between current household deposits and actual withdrawals (including interest and linkage increments). Accordingly the aggregates measured here represent the net amount of funds absorbed, comparable with and constituting part of saving as defined in the national accounts—namely the extent to which the public refrained from consuming its disposable income. By contrast, the changes in claims represent the net change in financial assets and are not indicative of a corresponding change in current saving as defined in the national accounts. However, this by no means derogates from the importance of the data on the net changes in the economy's claims and liabilities, which, as already noted, are of great importance in analyzing the structural development of the public's financial assets portfolio. But such data cannot serve to explain changes in current saving, and to attempt to do so may only be misleading. For example, in a year marked by high inflation the ratio of principal to interest and linkage differentials in the case of savings withdrawals declines sharply, and a measurement of saving according to the change in net claims shows it to be much higher than it actually was.

(c) The system used here distinguishes between flows of funds arising from medium- and long-term financial intermediation and the net change in short-term money market transactions. While the institutions surveyed in this chapter engage primarily in medium- and long-term financial intermediation, a small but significant percentage of their operations, as already noted, is in the short-term money market. This differentiation, which was not made in the flow-of-funds system employed in earlier years, enables us to obtain an accurate picture of capital market developments while simultaneously making it possible to analyze, at least partially, changes in the interrelationship between the capital and financial markets, and thereby to better understand the economic forces at work in the monetary sphere in general and the various segments of the monetary sector in particular. For example, in a year when short-term credit is tight and liquidity in short supply, a part (or a larger part) of the net resources mobilized by the capital market that year will be diverted to the short-term credit market, and vice versa.

3. GOVERNMENT INFLUENCE ON THE SYSTEM'S OPERATIONS

The degree to which the government determines the character and volume of the institutions' operations far transcends the weight of the latter's direct financial transactions with the government. In fact, as will be explained below, the government is involved in the whole financial intermediation process. This applies to (a) the mobilization of primary sources of funds (mostly household saving through social insurance companies, approved saving schemes, and mutual funds); and (b) the intermediate stage, i.e. the onlending of the bulk of the funds so mobilized to secondary financial intermediaries¹⁰ through the purchase of bonds and the placing of deposits for loan purposes by the primary financial intermediaries; and (c) the final stage, the channeling of funds to the productive and service sectors of the economy and households for financing production and consumption.

As regards the first stage, the government is responsible for the lion's share of the economy's voluntary savings finding its way to the system of intermediaries, as it directly and indirectly permits them to guarantee a 3-6 percent real return on long-term saving, regardless of the rate of inflation, besides granting income tax concessions on income from this source. The upshot is that the government has in effect prevented the development of a capital market worthy of its name alongside that discussed here—one that can compete in raising funds from domestic sources. At the same time government intervention has undoubtedly had a very positive effect on the level of saving in the economy, especially in periods of high inflation. The price paid for guaranteeing savers a return in excess of what they could earn in the open market lies in the distribution of income.

As to the second stage, by requiring the primary financial intermediaries to divert 80-90 percent of their resources to the acquisition of bonds (considered a recognized investment for purposes of the regulations), the government assures that most of the funds so raised go to the purchase of financial institution bonds as well as its own issues.

Regarding the third stage, every financial institution seeking to raise capital through the flotation of bonds (or other securities) has to obtain a special permit for this; this applies in particular to institutions desiring recognized investment status (for the purposes of the regulations governing the placing of primary financial intermediaries' resources) for a proposed bond issue. The Treasury can make the receipt of the permit conditional on the institution's agreeing to the allocation of the issue proceeds (either wholly or in part) in accordance with its guidelines. The

¹⁰ The reference is to the financial institutions and earmarked loan deposits in the banking system.

Treasury actually makes extensive use of this power, and it directly and indirectly controls the overwhelming portion of such proceeds, in conformity with national development policy. It makes loan capital available on unlinked, relatively inexpensive terms for high-priority activities and needs, using the proceeds of its own bond issues to the financial intermediaries and part of the latter's issue proceeds deposited with it on terms matching those of the bonds. Some of these funds flow back to the institutions for granting soft loans at the government's behest; the deposit terms take into account the terms on which the credit is to be granted, as well as the institutions' guaranteed profit margin. However, only a relatively small share of the preferred activities and requirements is financed by the public sector in this fashion. The greater part of such low-cost credit is granted directly by the financial institutions from their own bond issue proceeds in accordance with government directives, with the Treasury compensating them for the difference between the price of the capital so raised and the linkage terms on the one hand and the terms of the credit they extend on the other.

In actual fact, the preponderant share of the credit originating in bond issue proceeds is directed by the government, and is granted on unlinked, low interest terms, with the Treasury covering the linkage differentials. Even that relatively small part of the bond issue receipts that is defined as free of government control for the most part constitutes the institutions' contribution to the subsidized credit funds from their freely loanable resources, and this because of their desire to assure Treasury coverage of the linkage differentials. Their bargaining with the Accountant General over this portion is explained by the simple fact that it carries a higher profit margin.

One other facet of the government's intervention should be noted. The raising of capital abroad likewise requires a special permit from the Treasury's Foreign Exchange Department, and the prospects of lending out the funds on exchange-rate linkage terms are very slim in the prevailing circumstances; accordingly the institutions tend to grant such loans too in conformity with public sector guidelines so as to be entitled to linkage differential coverage. This gives some notion of how much the government influences the nature and volume of the business conducted by the system of intermediaries discussed in this chapter.

At the same time the institutions transact some autonomous credit business (on a relatively modest scale) with monies obtained from provident and pension funds, insurance companies, and approved saving schemes, as well as from business concerns and various other sources. However, it is very likely that because of improper supervision some funds which were originally intended for the granting of concessionary loans in accordance with public sector directives were subsequently used autonomously. The reference is to that part of the institutions' bond issue proceeds which at the outset is earmarked for the provision of directed loans. When

the flow of repayments of such debts is shorter than that of bond redemptions (the bonds issued for this purpose are generally for periods of 17 or 20 years), very little can be done to prevent the institutions from putting the funds to their own use in the interim period.

4. SOURCES OF FUNDS

(a) *General*

The intermediaries' principal source of funds is the household sector, which mainly takes the shape of savings through social insurance funds, insurance companies, approved saving schemes, and mutual funds. Besides such savings, which can be precisely identified, in recent years households have been supplying a growing volume of funds through direct secondary market purchases of securities issued and/or sold by the institutions. There is no way of isolating this portion, but the net proceeds from the issue and redemption of securities and from trade in the institutions' securities by households and business combined can be reliably estimated (see Table XVIII-1).

Businesses, besides borrowing from the intermediaries, also supply it with funds (albeit on a relatively modest scale) in the form of earmarked loan deposits (primarily for financing households), as well as through the purchase of financial institution bonds. Also included in this source are the monies transferred by the State Lottery, chiefly for onlending to local authorities. Other (quite modest) contributing sectors are the National Institutions and the rest of the world.

Another, more significant, source is current payments (principal, interest, and linkage differentials) on account of borrowers' (households, business, and local authorities) obligations. This source, over whose current dimensions the intermediaries exercise no control (it is a function of the volume of their operations in the past), has in recent years accounted for more than a third of total resources.

Not all the receipts from the sources listed above are lent to the producing and consuming public. Part is absorbed by the government and the banking institutions, whose relations with the intermediaries are quite complex. The government pumps out money for financing its operations, including *inter alia* the placing of deposits with the institutions for granting loans. The banks, which mobilize funds for their affiliated financial concerns, channel to them a sizable share of the intermediaries' resources, part of which flows back to the latter and is redistributed among the secondary financial intermediaries.

(b) *Volume and composition of sources*

The resources available to the system for onlending to the various productive and service sectors, households, and local authorities swelled 53 percent in 1974 to reach IL 5,555 million, after deducting a net IL 1.7 billion flow to the government and the banking system (IL 1,273 million in 1973). The gross flows arising from the intermediaries' operations totalled IL 18.5 billion, a third of which was within the system itself (see Table XVIII-2).

The amount of household savings obtained through the insurance sector and mutual funds expanded by a record 150 percent to hit IL 4,590 million, bringing up the weight of this component from 35-40 percent in the last few years to 63 percent. This gain was partly at the expense of some household disinvestment in financial institution bonds acquired directly.

Another component that expanded notably was earmarked loan deposits by business concerns, which rose from IL 175 million in 1973 to almost IL 400 million. On the other hand, the share of loan repayments predictably fell off in this year of high inflation, since the majority of the loans extended to the various productive and service sectors and to households are unlinked.

As opposed to the sharp upswing in the intermediaries' resources in 1974, the net flow to the government increased by a fairly slow 18 percent. This was not due to any reduction in the government's share of the intermediaries' bond issue receipts, but stemmed from an enormously larger volume of government payments on account of linked liabilities, coupled with a fairly laggard growth of income from its unlinked assets held with the system.

(c) *Households and business*

The amount received from households and business (net of loan repayments) soared 52 percent to stand at IL 4,388 million, with contractual household savings, approved saving scheme deposits, and mutual fund shares accounting for the overwhelming portion. These added up to IL 4,587 million net of withdrawals, a 150 percent gain. In social insurance funds and insurance companies the increases were 63 and 70 percent respectively (20-30 percent in real terms), while for approved saving schemes and mutual funds they came to 230 and 316 percent respectively (see Table XVIII-3).

Together with this impressive growth of savings, households unloaded part of their direct investment in securities. As a result, whereas in 1973 households and business contributed IL 857 million to the intermediaries through the direct purchase of their securities in the primary and secondary markets, in 1974 there was a IL 596

Table XVIII-3

FUNDS SUPPLIED TO THE SYSTEM BY HOUSEHOLDS, BY SOURCE, 1973-74

(IL million)

Source	1973			1974		
	Deposits	Withdrawals ^a	Net	Deposits	Withdrawals ^a	Net
Social insurance fund						
savings	1,571.9	684.9	887.0	2,571.0	1,065.7	1,505.3
Approved saving schemes	1,066.2	523.9	542.3	2,585.1	797.8	1,787.3
Mutual funds	276.6	36.2	240.4	1,247.0	247.2	999.8
Life insurance	286.4	105.9	180.5	442.0	148.0	294.0
Subtotal						
IL million			1,850.2			4,586.4
Percent increase						148
Net receipts from security transactions—households and business ^b			856.7			-595.7
Total						
IL million			2,706.9			3,990.7
Percent increase						47^c

^a Principal, interest, and linkage increments.

^b Purchase of original-issue securities by the system of intermediaries, less redemptions and net sales in the secondary market.

^c If direct purchases (net of redemptions) of government securities by households and business (IL 576 million in 1973 and IL 274 million in 1974) are added, the growth rate falls to about 30 percent.

million flow in the opposite direction. Households also slashed their direct purchases of government securities from IL 576 million (net of redemption) in 1973 to IL 274 million.

This shift of households from a relatively liquid financial saving (bonds) to a much less liquid one (through the system of intermediaries) took place without any significant increase in the relative yield of the latter. It was apparently connected with the rumors abounding about a mooted adverse change in the bond terms through the taxing of linkage increments. Household behavior was apparently influenced by the hope and/or the advice of financial concerns that savings through the intermediaries would fare better than a direct security investment. This further boosted the weight (and profits) of the institutions in the total amount of savings mobilized, at the expense of direct noncompulsory government issues to households.

The amount procured from business (deposits and sales of original-issue securities) also rose appreciably this year—IL 397 million as against IL 175 million in 1973. The bulk of this sum, however, consisted of building company deposits for granting

mortgage loans to households (to stimulate the sale of homes) and State Lottery deposits, intended mainly for financing local authorities.

The total flow of private sector savings (not counting the directly identified contribution of business) to the intermediaries expanded by 47 percent in 1974 (see Table XVIII-3). This far outdistanced the growth of the sector's voluntary savings (9 percent according to the national accounts) as well as its total voluntary financial savings, which also rose quite mildly this year. This increase in the system's share of total private voluntary savings in general and financial savings in particular was only partly at the expense of direct government security issues. It was also connected with the switch from savings through the intermediaries to other financial instruments. In this context it should be noted that in 1974 households stepped up their Short-Term Loan purchases and local and foreign currency time deposits in commercial banks by only IL 595 million, as against IL 1,065 million in 1973.

(d) *Loan repayments*

Current repayments of borrowers' obligations were, at IL 2,695 million, up 44 percent in 1974. As already mentioned, in recent years this source—which is largely autonomous and over whose size the intermediaries have no control—has accounted for about a third of their total funds. If such credit had been granted value-linked, or if the general price level had moved up at a modest pace over the years, the weight of this source might have been expected to rise progressively. But the lion's share of the credit to both households and business has been granted unlinked. By contrast, that supplied to local authorities has been mostly pegged to the consumer price index; with the swelling of local authority expenditure and the acceleration of inflation in 1974, loan repayments doubled in volume.

(e) *Government and banking system absorption*

The net amount absorbed by the government from the institutions surveyed here rose by a fairly modest 18 percent to reach IL 1,353 million. This sum, which constituted 19 percent of their total sources in 1974, by no means reflects the overriding extent of government intervention in the system's operations, as explained in section 3.

The government's financial relations with the system are quite complex. Essentially they fall into four categories (see Table XVIII-4):

(1) Part of the system's resources flows to the government in the form of financial institution deposits of some of the bond issue proceeds and the sales of government bonds to the various segments of the system (see col. 5 in Table XVIII-4).

Table XVIII-4
FLOW OF FUNDS BETWEEN THE SYSTEM AND THE PUBLIC SECTOR AND INTRASYSTEM FLOWS, 1973-74
 (IL million)

Public sector authority	Year	Receipts o/a	Payments o/a	Surplus of	Current	Current	Surplus of	Total
		long-term assets ^a	long-term liabilities ^a	long-term receipts over payments (1-2)	long-term receipts ^b	long-term payments ^b	current receipts over payments ^b (4-5)	surplus (3+6)
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
Government	1973	1,070.0	351.0	719.0	773.0	2,636.1	-1,863.1	-1,144.1
	1974	2,018.3	347.9	1,470.4	1,036.0	3,859.4	-2,823.4	-1,353.0
National Institutions	1973	80.4	18.2	62.2	36.7	15.9	20.8	83.0
	1974	109.8	17.1	92.7	54.7	16.7	38.0	130.7
Local authorities	1973	300.2		300.2		459.2	-459.2	-159.0
	1974	591.7		591.7		784.3	-784.3	-192.6
Intrasystem flows	1973	932.4	932.4	—	2,492.4	2,492.4	—	—
	1974	1,499.1	1,499.1	—	4,233.5	4,233.5	—	—

^a Deposits, loans, and securities (including interest and linkage differentials received and paid). Col. 1 consists mainly of repayments of past deposits, and col. 2 of redeposits.

^b Deposits, loans, and sales (and purchases) of securities. In the case of the government, col. 5 consists mainly of deposits of security issue proceeds, and col. 4 of sums redeposited by the government.

(2) The government places deposits with the system's secondary financial intermediaries for granting loans in conformity with its guidelines (col. 4).

(3) The government repays linked debts to the system (col. 1).

(4) The system makes repayments to the government on account of the latter's assets held with it (col. 2).

Whereas the first two flows arise out of current decisions, the last two are a function of the volume of past transactions.

The sluggish rise in the government's net absorption in 1974 did not reflect any diminution of its share in the funds raised by the system or a relative increase in its redeposits with the latter. The system's deposits (net of redeposits) with the government were, at IL 2,823 million, up 52 percent. On the other hand, the high rate of domestic inflation in 1974, together with the fact that all the government's liabilities to the system are value-linked whereas most of its assets are unlinked, caused the government's net repayment burden to more than double to IL 1,470 million. This forced it to roll debts to a much greater extent this year, with all the attendant budgetary difficulties involved.

In contrast to the fairly small increase in the government's net absorption, that by the banking institutions shot up by IL 212 million to IL 347 million (see Table XVIII-1). The latter, as already noted, fulfill the function of mobilizing funds for the financial concerns to which they belong, which as a rule include social insurance funds, insurance companies, approved saving schemes, mutual funds, investment companies, development banks, and mortgage banks. On the other hand, the large banking houses channel to them a sizable portion of the system's resources, the overwhelming share of which is transferred back to it and redistributed among the secondary financial intermediaries. In 1974 the amount drained off in this way came to IL 1,727 million, of which IL 347 million did not flow back to the system. The much larger net absorption this year was apparently connected with the commercial banks' tight liquidity situation throughout most of the year.

5. CREDIT TERMS AND DESTINATION

(a) *Credit terms*

Most of the gross medium- and long-term funds provided by the system consists, as noted above, of unlinked, low interest credit granted directly or indirectly at the public sector's behest and at its expense. This is especially true of the credit supplied to households, agriculture, and industry, 80-90 percent of which has been granted on concessionary terms in recent years; it also applies to part of the financing made available to the construction industry, and to a much lesser extent to that provided to

local authorities.

Development credits extended in accordance with government guidelines to industry, agriculture, and tourism (hotel construction loans are classified here as credit to the construction industry) have since the mid-1960s been granted unlinked and at a quite low nominal rate of interest. In most cases interest has ranged from 6 to 9 percent (on loans approved from July 1974 onward it is 8-12 percent), with the rate depending on the location and economic destination of the output. In actual fact, the approvals for most of the loans disbursed in 1974 were issued before July 1974, so that the bulk of the financing carried the lower rates. Another part of the subsidized credit to these sectors has been granted unlinked at 12-13 percent, at the behest of authorized public bodies:

Directed mortgage credit (and some of the other credit to households) is also unlinked and bears interest of 7-13 percent. In the case of part of the nondirected mortgage credit for private housing, which is subject to certain price and space limitations, the mortgage banks are likewise allowed to grant it unlinked, at interest now ranging from 12 to 20 percent (depending on the price of the home).

By contrast, most of the credit to the service sector (and part of that to the local authorities) is linked either to the cost-of-living index or the foreign exchange rate, with interest amounting to 6-7 percent for the former and somewhat more for the latter.

The interest rates on development loans to industry, agriculture, and tourism, as well as those on directed mortgage credit, were set by the public sector in 1967-68, when the linkage clause was lifted on most of the medium- and long-term credit; until 1970-71 these rates were expected to represent a 3-4 percent real cost in most cases (on the assumption, reasonable at the time, that in the long run prices would move up by an average of 6-8 percent a year). But the intensification of inflation from 1970 onward was not accompanied by an appropriate revision of interest rates. Accordingly the subsidy element in development and mortgage credit rose appreciably, and precisely during a boom period (1970-73), when the economy certainly did not require any increased stimulus. This was tantamount to rewarding current investments (and even more, those made in the past), as the real debt repayment burden decreased sharply; hence it mainly affected the distribution of income in the economy.

The modification of interest rates by the public sector in the second half of 1974 was long overdue; however, it can hardly be considered adequate (a rise of only 2-3 percent), even if allowance is made for the anticipated slowdown of inflation, which will still leave a negative real interest of at least 10 percent. The directed credit supplied this year to agriculture, industry, and tourism, as well as preferred groups of home buyers, carried a negative real interest of about 30 percent.

(b) *Volume of credit*

Gross medium- and long-term lending by the system of intermediaries was, at IL 4,770 million, up 49 percent in 1974; this contrasts with a 26 percent increase in 1973. In real terms the growth rates were similar (6.7 percent), but 1974 saw two major structural changes. One was a significant rise in the already high proportion of subsidized credit, which this year accounted for the preponderant portion of the financing supplied to home buyers, agriculture, and industry. On the other hand, the weight of investment financing supplied to the productive and service sectors (particularly industry) dropped sharply, while that of loans to households and local authorities went up.

These changes were more or less compatible with developments in the economy's real transactions. The faltering of investment demand in 1974 was reflected by a fairly small increase in nondirected credit for this purpose (which is generally proportional to the volume of nominal investment) and a diminished demand by private investors for linked nondirected credit; the latter development can apparently be ascribed to the slowdown in capital spending, which brought up the proportion financed from equity funds. At the same time the trailing of disposable income behind the rise of prices in general and housing prices in particular generated strong demand pressure for subsidized mortgage credit, which is repayable on easy terms. In response to this pressure, the public sector stepped up its lending to a record high.

As to the local authorities, their capital outlays rose 52 percent in current price terms, while medium- and long-term finance made available to them expanded by a

Table XVIII-5

GROSS MEDIUM- AND LONG-TERM CREDIT GRANTED, 1973-74
(IL million)

	1973		1974		Percent increase
	IL m.	%	IL m.	%	
To households	1,079.5	34.2	1,886.4	40.0	74.7
Mortgage credit	767.0		1,444.9		88.4
Other credit	312.5		441.5		41.3
To productive and service sectors	1,621.4	51.3	2,046.5	43.4	26.2
Agriculture	386.6		504.7		30.5
Industry	823.4		944.0		14.6
Construction	240.7		344.4		43.1
Services	170.7		253.4		48.4
To local authorities	459.2	14.5	784.3	16.6	70.8
Total	3,160.1	100.0	4,717.2	100.0	49.3

much faster 71 percent. The total amount obtained from the system of intermediaries came to IL 785 million gross (excluding direct public sector funds), whereas their investments added up to only IL 873 million. This is explained by the fact that part of the borrowed funds was used to roll debts. Long-term debt repayments to the system nearly doubled this year—from IL 300 million in 1973 to IL 591 million. The intermediaries also deal, as mentioned, in short-term credit. Although such business is not very large, the changes that take place therein over time can sometimes help to make more comprehensible the developments in the money market. This is especially true of 1974, when it was not entirely clear whether the net absorption (a resultant of the appreciable sum siphoned off via the balance of payments and a sizable liquidity injection by the government and the Bank of Israel) was stronger or weaker than the endogenous forces at work in the system, which accompanied the subsiding of demand for money because of the rising cost of holding such balances. In a year when there is ample liquidity in the system and part is absorbed by the capital market, it is reasonable to assume that the intermediaries will experience a similar development, i.e. a diminished resort to medium- and long-term funds for short-term purposes, while in a year of tight money and liquidity shortage the opposite situation will prevail, i.e. an increased use of medium- and long-term funds for short-term transactions. In 1974 the system's net short-term credit outflow amounted to IL 354 million, as opposed to IL 31 million in 1973 (see Table XVIII-6). This strengthens the supposition that, despite the large liquidity injection by the government and Bank of Israel, credit was tight and liquidity difficulties were encountered this year.

Table XVIII-6
NET SHORT-TERM USES OF FUNDS,^a 1973-74

(IL million)

	1973			1974		
	Increase in out- standing short-term liabilities	Increase in out- standing short-term assets	Net uses	Increase in out- standing short-term liabilities	Increase in out- standing short-term assets	Net uses
Social insurance funds	25.6	39.5	13.9	13.1	75.3	62.2
Insurance companies	79.5	228.1	148.6	117.0	203.8	86.8
Financial institutions	201.5	69.9	-131.6	52.5	258.1	205.6
Total	306.6	337.5	30.9	182.6	537.2	354.6

^a Excluding short-term items not involving fund-flows (e.g. allocations to reserves, etc.).

(c) *Credit to households*

Gross lending to households in 1974 spurred 75 percent (25 percent in real terms) to stand at IL 1,886 million, of which fully 77 percent was mortgage financing. It is noteworthy that a large percentage of other household credit, most of which is granted by social insurance funds to their members, is apparently also used to help finance the purchase of homes. Part of this credit is unlinked and part is indirectly linked, in the sense that the borrower forgoes for the period of the loan the linkage of a corresponding amount of his savings with the fund. The increased use of this component also suggests that home buyers were pinched for money (because of the jump in housing prices and the relatively slow growth of disposable income), despite the record expansion of mortgage lending.

Whereas in each of the last few years gross credit for this purpose went up 30-40 percent per annum (more or less matching the rise in housing prices), this year it shot up 90 percent to reach an impressive IL 1,445 million, while prices advanced only 40-45 percent. This did not square with demand developments. In 1974 (and probably as early as the second half of 1973) demand began to let up; the first signs of this actually appeared in the final months of 1972, when the housing boom began to peter out and demand pressure eased somewhat. This was reflected by a drop in home sales (and an increase in the stock of unsold units), with housing prices limping behind residential building costs. In an economy where there are no subsidized mortgage loans and financing is available for almost the entire price of the home (e.g. in the Western countries), the growth of mortgage credit might have been expected in such circumstances to lag behind the advance of housing prices, if only because of the downturn in sales. But this does not hold for an economy like Israel, where the bulk of the mortgage credit is subsidized and hence the rate of financing falls far short of the full price of the dwelling. Along with the drop in home sales in 1974, there was a livelier demand for low-interest mortgage loans, due both to the steep increase in the subsidy element (in the wake of the accelerated rise of consumer prices)¹¹ and to the much larger sums buyers had to provide out of their own pockets because of soaring home prices. Demand was heaviest for public sector financing on the part of new immigrants, families relocated under urban renewal schemes, young couples, Saving-for-Housing Scheme members, and veteran settlers, as well as for the purchase of dwellings in the private market. Credit for the latter is granted subject to various area and price limitations, which entitle the buyer to the Treasury's linkage-

¹¹ In 1974 recipients of unlinked mortgage credit enjoyed a 20-30 percent reduction of their real indebtedness in the very first year.

differential guarantee in return for the payment of an unrealistic annual premium.¹²

The fact that in 1974 directed mortgage credit (except that to new immigrants) more than doubled, while the amount of financing made available for private housing expanded by 70 percent (even though that part that was not subsidized decreased because of the softening of the housing market and the charging of interest at the higher open-market rate) indicates that the public sector responded to an unprecedented degree to the demand pressure for mortgage credit subsidized directly or indirectly by the Treasury. This slowed the downswing in housing demand in the year reviewed. Nevertheless, partial data for the end of 1974 and early 1975 point to a significant weakening of demand for such financing, apparently because of the relative stabilization of prices and the pessimistic outlook of the public with regard to their future income. In other words, in the final months of the year reviewed there may have been a change of trend, with the ample supply of subsidized credit no longer able to stem the ebbing of housing demand.

The public sector met the more buoyant demand for such credit in 1974 in various ways: with respect to financing granted in accordance with government guidelines its response was mostly direct, while as regards subsidized credit for private housing it was chiefly indirect.

Directed mortgage credit expanded by a resounding 92 percent this year to reach IL 1,215 million. Not counting loans to new immigrants, which went up only 25 percent because of the slackening of immigration and the small price rise of dwellings offered them by the public sector in comparison with the general index of housing prices, the growth rate was 102 percent. All classes of supported groups other than new immigrants shared in the increment. The amount supplied to slum dwellers and those registered in the Saving-for-Housing Scheme went up 50-60 percent, that to young couples by 160 percent, and other credit (to the veteran population in the development areas, those living in overcrowded conditions, and a small part given as supplementary financing to the aforementioned groups) shot up 105 percent.

Several measures taken by the public sector can be singled out to explain the accelerated expansion of directed mortgage credit in 1974:

1. An increase in the size of the loans given to newlyweds and those registered in the Saving-for-Housing Scheme.

2. The granting to discharged soldiers of an extra 20 percent over and above the authorized amounts. The increment went to a large majority of the newlyweds, a high percentage of those in the Saving-for-Housing Scheme, and a not insignificant number of home buyers in the other preferred groups.

¹² With respect to such credit, which is granted unlinked, the public sector has set a 13-20 percent ceiling (including the premium) on the interest which mortgage banks may charge.

Table XVIII-7

GROSS MORTGAGE BANK CREDIT, 1972-74

(IL million)

Recipient group	1972		1973		1974	
	IL m.	No. of loans	IL m.	No. of loans	IL m.	No. of loans
Directed credit						
New immigrants	150.1	5,052	140.8	3,761	174.8	3,662
Slum dwellers	29.0	1,825	38.7	2,121	58.4	2,614
Saving-for-Housing Scheme	65.4	2,178	108.8	3,389	171.2	4,291
Young couples	106.2	5,345	198.9	7,947	513.9	17,579
Other	128.9	7,961	144.7	7,734	297.1	11,505
Total	479.6	22,361	631.9	24,952	1,215.4	39,651
Other credit						
Private housing	104.8	6,653	135.1	7,406	229.5	9,047
Total mortgage credit	584.4	29,014	767.0	32,358	1,444.9	48,698

3. The introduction of a new plan to help families living in dwellings with a density of over three persons a room. Under this arrangement such families may receive mortgage loans of up to IL 80,000 at interest of 5-6 percent for periods of 17 to 25 years. The plan was slated to go into effect in the middle of 1973, but disbursement of the loans was put off to 1974 because of the war. The total amount provided during the year is estimated at about IL 100 million.

Besides these three steps, there were apparently other supply factors stimulating the expansion of directed mortgage credit, although it is not certain whether they were an outcome of deliberate public sector policy. The number of directed mortgage loans in 1974 rose 58 percent (70 percent excluding immigrants) to reach some 40,000. As already mentioned, this happened even though the sale of homes to these groups not only failed to increase in 1974 but actually fell off. Since it is estimated that only a relatively small percentage of the extra loans went to families living in crowded conditions and to discharged soldiers, it may safely be concluded that in the year reviewed a larger number of persons were entitled to mortgage credit on concessionary terms because of the more liberal application of the relevant criteria. It also seems that the supported groups were permitted, to a greater extent than ever before, to obtain such financing from more than one source. Hence the rate (and percentage rise) of mortgage loans granted to these groups in 1974 was greater than indicated by the change in the average loan size.

Total nondirected mortgage credit for private housing rose 70 percent to IL 230

million. Since the relatively small share given at the going open-market rate decreased, the unlinked portion obviously increased by more than 70 percent. The acceleration of inflation in 1974 brought up the subsidy element in such financing well beyond its level in the past, so that it is no wonder that it was in much heavier demand. The public sector indirectly helped to satisfy a good part of the extra demand by raising the maximum home value eligible for the Treasury's index-linkage guarantee and by amending the regulations at the end of 1973 to permit the granting of mortgage loans after completion of the building skeleton, instead of at the time the home is turned over to the buyer.

(d) *Industrial credit*

The growth of gross long-term industrial credit slowed noticeably in 1974. Whereas in 1971 and 1972 it expanded by 33 and 35 percent respectively, in 1973 the rate fell to 25 percent and in 1974 to 15 percent. Although the trend continued downward in 1974, developments in the last two years differed widely. In 1973 the deceleration was accompanied by the slackening of nominal investment growth, but in the year surveyed it occurred despite a vigorous increase in investment (33-35 percent). Gross medium- and long-term industrial credit came to IL 945 million in 1974, covering 43 percent of the sector's total capital expenditure at current prices, compared with 50 percent in 1972 and 1973.

Estimates of the directed and nondirected credit proportions show a sharp absolute drop in the latter component (linked to the consumer price index), and it was this that pulled down the overall growth rate.

Table XVIII-8

INDUSTRIAL INVESTMENT CREDIT, 1973-74

(IL million)

	1973	1974
Gross medium- and long-term credit granted	823.4	944.0
Industrial investment, at current prices	1,650.0	2,200.0
Ratio of credit to investment (%)	50	43

To be sure, in previous periods of buoyant economic activity and escalating prices unsubsidized credit declined more than once, but this always coincided with the modification of the eligibility criteria for loans granted on concessionary terms,

which led to a hefty growth in such financing and thus a diminished resort to nondirected credit, which had become dearer in the meantime. These boom periods always saw an increase in financial leverage, a result of a much heavier capital spending and one manifestation of investors' optimistic expectations.

In 1974 the picture changed. The sharp drop in nondirected credit was not caused by any revision of the criteria permitting the rapid growth of soft credit (on the contrary, the criteria were neither stiffened nor applied more rigidly; nonetheless, the increase in such credit lagged a little behind that in nominal investment, for various reasons which will be explained below). Rather, it was due to slackened capital spending. Uncertainty about future demand for their products increased manufacturers' risk aversion and induced a more cautious, selective attitude toward investment. This in itself improved the ratio between equity finance and total (reduced) investment, thereby decreasing the need for nondirected credit, which, as already noted, became much costlier in 1974 because of the aggravation of price inflation.

One other development that requires explanation is the trailing of industrial development credit behind the growth of nominal investment—28 vs. 33-35 percent. Most of this subsidized financing is supplied in conformity with industrial development policy guidelines, and is made available in stages as the investment project progresses. A smaller fraction constitutes supplementary financing given at the behest of other public bodies (notably Hevrat Ha'Ovdim, the Histadrut holding company), and sometimes there is only a slight connection between the disbursement of the loan and actual implementation of the project. In the year reviewed both categories rose by only 27-28 percent, even though there were no signs of any tightening of the eligibility criteria. This lag can be only partly attributed to the disbursement of loans earlier than usual; it apparently happened in the final quarter of 1973 and had a dampening effect on the measured growth of investment finance in 1974. Another part is probably explained by a change in the geographical distribution of investments implemented in 1974, to the detriment of the development areas, which are entitled to higher rates of funding. It should be stressed, however, that this is pure conjecture, for at the time of writing this chapter no data were available on the regional breakdown of investment in the year reviewed. Such a change may also help to explain the sluggish expansion of industrial investment grants, which, at IL 112 million, were only 12 percent up on 1973. This does not jibe with the growth of nominal investment, unless 1974 saw a significant structural change to the disadvantage of exports—which is implausible. The share of the textile and food industries in total investment finance declined in 1974, while increases were recorded for the metal and chemical industries, whose exports have made big strides of late. This in itself suggests that, along with the sagging uptrend

in total industrial capital spending, there was an increase in the share of export industries.

While the capital investments law stipulates that only establishments marketing most of their output abroad are eligible to receive grants, for many years the public sector has disregarded this criterion in the case of enterprises in development areas. The downswing in the percentage of investments made in these areas therefore held back the growth of such financing, which was probably accentuated by technical delays encountered in disbursing the grants because of budgetary problems.

In 1974 the subsidy element in directed credit increased more than in any other year since the linkage clause was lifted and industry was accorded preferential investment credit terms. This was due to the accelerated rise of prices in the economy. Whereas the loans granted this year carried interest of 7-12 percent, the consumer price index moved up 40 percent on an annual average. If we conservatively estimate the subsidy element in the investments carried out in 1974 at about half the difference between the rise in the cost of subsidized finance and that of production and turnover, we arrive at a figure in excess of IL 100 million. It must be stressed that this is unquestionably downward-biased and relates to a single year and only to soft loans granted that year. If we perform a similar exercise for all such loans outstanding, the figure will come to around IL 500 million.

After fairly protracted deliberations, two changes were introduced in the second half of 1974 in the terms of subsidized industrial development credit:

1. In July interest on development loans to industrial establishments was raised from 7-9 percent (depending on the regional location) to 8-12 percent, and to semi-industrial concerns from 12 to 15 percent—a step that made such financing only 1-3 percent dearer. But this modest rise did not affect the big majority of the loans granted in 1974, since they had been approved before the determining date (it will be recalled that there was a big increase in approvals in the year prior to the interest rate revision); for the same reason, most of the loans disbursed in 1975 presumably will also carry the easier terms.

2. Another, and also fairly mild, change was introduced in November. It provided that henceforth all establishments in developed areas applying for a development loan must undertake to pay linkage differentials if the consumer price index should go up by more than 20 percent in any single year. The calculation is to be made by multiplying the principal outstanding by the rate at which the rise in the price index exceeds 20 percent. If it had been decided that the differentials were to be paid currently, this would have been tantamount to a partial but significant restoration of index-linkage—a step that would have put a ceiling on inflation gains. But this was not done. Instead, it was stipulated that the differentials are to be added to the principal and paid at the end of the loan period, plus interest at the same rate

as on the loan itself. This removes much of the sting of the "partial linkage" clause, as it can only slightly reduce the capital gains earnable on loans taken on during an inflationary period. To illustrate this, an annual price rise of 30 percent would increase the cost of subsidized loans in developed areas by less than 3 percent.

(e) *Agricultural credit*

Gross long- and medium-term agricultural credit lagged far behind the growth of the sector's nominal investment—30 vs. 43 percent (excluding land amelioration, afforestation, drainage, and so forth, which are chiefly direct public sector investments). Nevertheless, the amount of financing provided still covered 92 percent of total investment. This must be seen in conjunction with the strong uptrend in the rate of financing in previous years: the increase far surpassed that of nominal investment and caused the volume of credit to exceed total investment in 1972-73.

The lion's share of the funding is subsidized credit granted in accordance with Ministry of Agriculture and Jewish Agency guidelines by the group of institutions specializing in this area. The criteria governing its supply assure such financing for up to 90 percent of the value of the investment, but because of the ramified system of intermediation, the actual figure can conceivably come to more than this. At the same time it may also be that part of the sum granted to agriculture under the supervised credit and other arrangements is initially intended to finance other economic activity (nonfarm construction, purchase of durables, and so forth).

Table XVIII-9

AGRICULTURAL INVESTMENT CREDIT, 1973-74

(IL million)

	1973	1974
Gross medium- and long-term credit granted to farms	386.6	504.7
Agricultural investment at current prices (less land reclamation and conservation, afforestation, drainage, etc.)	385.0	550.0
Ratio of credit to investment (%)	100.0	92.0

It should also be noted that the long- and medium-term credit provided by the system to this sector does not constitute all its financing. A significant share flows directly from the public sector and is not included in the data on the intermediaries surveyed here. Hence, despite the aforementioned reservations, it may be concluded that the amount of medium- and long-term financing extended to agriculture almost

certainly exceeded its investment, and that some of the long-term funds were used for meeting the sector's working capital requirements and/or for consolidating debts arising out of past investments.

The present value of the subsidy element in directed agricultural credit is much higher than that in industrial credit, even though the interest rates are the same. This is because agricultural loans are for longer periods—generally 17 years (and in some cases even more), compared with eight years for industry. For this reason, the jump in the subsidy element of such credit with the rapid rise in the general price level poses a more acute problem in the case of agricultural financing. In 1974 alone the decline in the sector's real liabilities to the system amounted to some IL 500 million.

(f) Credit to the rest of the economy

Medium- and long-term lending to the construction industry was, at IL 345 million, up 43 percent. This includes IL 125-130 million for the erection of hotels; in nominal terms the level of such financing hardly rose this year, and in real terms it fell off 25 percent. This was an inevitable outcome of the huge hotel investment in preceding years.

Other construction credit, mostly for medium terms, came to IL 210 million, compared with IL 115 million in 1973. These are relatively small sums, which fall far short of the amount required by contractors and building companies. Presumably the construction industry, more than any other, depends chiefly on customers' credit and own sources.

The services received IL 253 million in medium- and long-term borrowed funds in the year reviewed—48 percent more than in 1973. Since the figure includes credit to holding companies, the amount given for financing actual investments was smaller. The services industry relies more heavily on funds borrowed abroad and from the public sector, with its dependence on the system of intermediaries being quite secondary.

II. COMPONENTS OF CAPITAL MARKET INSTITUTIONAL SYSTEM¹³

I. SOCIAL INSURANCE FUNDS

(a) *Structure of the sector and nature of its operations*

Approximately 240 social insurance funds administer pension, provident and severance pay schemes in Israel. Some of the funds also cover such social benefits as mutual assistance, holiday leave, convalescence, sickness, etc.; however, these account for only a small fraction of their activity.

The funds are divided into three main categories:

1. Histadrut-affiliated social insurance funds, which control over 90 percent of the pension schemes; 2. Social insurance funds managed by the banks, which control about two-thirds of the provident and severance pay schemes; 3. Social insurance funds administered by companies and enterprises. This group falls into all three categories; their share of pension and severance pay schemes is rather limited, but they administer approximately one-quarter of the provident schemes.

Following the rapid growth of household saving through provident schemes in recent years, the weight of pension schemes is on the decline: whereas in 1968 they accounted for about 56 percent of the funds' assets, at the end of 1974 the figure had dropped to 37 percent.¹⁴

Social insurance funds are primary financial intermediaries; they mobilize funds directly from sources of savings, allocate a small proportion of these directly, and transfer the bulk to other financial intermediaries, which, in turn, allocate them to various sectors of the economy and to households. Table XVIII-10 shows that most of the sector's resources originate in savings, and that about 75 percent of the total is transferred to other intermediaries (mainly financial institutions—see Table XVIII-12). These savings are defined as contributions from both employees and employers; however, conceptually fringe benefits can also be included in household savings, if they are defined as part of wages.

The law clearly favors saving through the social insurance funds (as through the insurance companies) over other forms of financial saving. The reason is that this encourages long-term contractual saving that assures households (employees and self-employed alike) a suitable income after retirement. This preference is expressed

¹³ In regards to savings schemes, see the survey in Chapter XVII.

¹⁴ Excluding revaluation differentials.

through various income tax benefits. The self-employed may deduct up to 7 percent of their income for contributions to social insurance funds (up to IL 2,100 per year). Employees whose employers have no provident or pension arrangements may deduct contributions of up to 5 percent of their income (up to IL 1,500 per year). On contributions in excess of these amounts, both employees and self-employed are entitled to a tax credit of 25 percent of their contributions up to IL 900 per year or 5 percent of their income up to IL 1,500 a year, whichever is higher. These are in addition to the tax benefits granted on the yields of such medium- and long-term savings.

Besides these regulations which enhance the attractiveness of social insurance funds for household saving, there are regulations that prescribe the manner in which the funds may invest their resources. The latter have two principal aims: 1. To

Table XVIII-10

SOURCES AND USES OF FUNDS — SOCIAL INSURANCE FUNDS, 1973-74

(IL million)

Sources	1973	1974	Uses	1973	1974
Savings deposits, net ^a	887.0	1,505.3	Net transfers ^b	738.8	1,256.4
Medium- and long-term debt repayment	157.0	199.4	Medium- and long-term credit granted	216.1	307.4
			Net change in short-term uses ^c	13.9	62.2
			Surplus of expenditure over income	50.7	48.2
			Net change in cash and demand deposits	24.5	30.5
Total sources	1,044.0	1,704.7	Total uses	1,044.0	1,704.7

NOTE: Receipts on account of medium- and long-term debt repayment, savings withdrawals, and redemption of securities include not only principal, but also interest and linkage differentials paid. In the past these components were defined in the flow-of-funds system as real (i.e. nonfinancial) transactions and included in the surplus of income over expenditure. In the present system the "surplus of expenditure over income" includes, in addition to payroll, service charges, purchase of real assets, etc., also interest received and paid on short-term transactions.

^a Net of withdrawals; contributions to severance pay funds are treated as household savings in this table.

^b The lion's share of these sums represents net purchases of securities.

^c The increase in outstanding short-term assets, less the increase in outstanding short-term liabilities.

safeguard savings by directing them into solid financial investments with a suitable real return.

2. To ensure that most of the funds' resources are utilized for what the public sector considers to be essential purposes. As explained in Section 3—"Government Influence on the System's Operations"—the Government directs the money to those financial institutions over which it has control in regard to the use of their resources.

The funds are obliged to invest 86 percent of their assets¹⁵ in certain index-linked bonds deemed to be a recognized investment for the purpose of the regulations. These recognized investments are mainly bonds that mature in seventeen or twenty years and bear interest of 6 or 6.5 percent respectively. In the first half of 1974, with the worsening of bond terms for the general public, the Treasury allowed the continued issuance of bonds to the funds under the previous terms. To prevent the funds from earning easy profits through excessive buying of bonds for resale to the public, the funds were forbidden to sell bonds that had been in their possession at the time the terms were changed, or to acquire 6 and 6.5 percent bonds in excess of the net increase in their accumulation plus redemptions of the existing stock of bonds.

(b) *Receipts and payments*

The resources at the disposal of the sector in 1974 expanded by 63 percent (16 percent in real terms) to IL 1,705 million. The inflow of loan repayments was up only 27 percent (see Table XVIII-10) despite the substantial increase in prices. The reason is that loans to households (which account for most of the loans) are partly unlinked and partly indirectly linked; linkage differentials are deducted from linkage increments and are not actually paid at the time the loan is repaid.

1. *Savings receipts*

Gross savings receipts increased by about 64 percent, reaching a peak of IL 2,570 million (see Table XVIII-11). Heading the list for the first time were the provident funds, which are largely controlled by the banks. Receipts in the pension funds grew 44 percent, in the provident funds, 95 percent, and in the severance pay funds, 32 percent.

While the growth of pension fund receipts corresponded roughly to the increase in the payroll of the private sector¹⁶ (about 35 to 40 percent), provident fund

¹⁵ This rate increased gradually from 80 percent in 1970; for the social benefit funds, the rate is only 50 percent.

¹⁶ Employees in the public sector receive budgetary pensions.

Table XVIII-11
FLOW OF SAVINGS, BY TYPE OF FUND, 1973-74
 (IL million)

Deposits	1973	1974	Percent increase	Payments	1973	1974	Percent increase	Net accumulation		Percent increase
								1973	1974	
Pension ^a	754.9	1,086.7	44.0	Pension	483.4	680.1	40.7	271.5	406.6	49.8
Provident ^b	632.6	1,232.0	94.8	Provident	122.9	260.3	111.8	509.7	971.7	90.6
Severance pay ^c	145.5	192.4	32.2	Severance pay	52.3	96.6	84.7	93.2	95.8	2.8
Mixed and other ^d	38.9	59.9		Mixed and other	26.3	28.7		12.6	31.2	
Total	1,571.9	2,571.0	63.6	Total	684.9	1,065.7	55.5	887.0	1,505.3	69.7

^a Including Histadrut and company funds.

^b Including bank-administered and company provident funds and advanced study schemes.

^c Including bank-administered central severance pay funds and company funds.

^d Including company funds administering provident and severance pay schemes combined and paid-vacation schemes.

receipts almost doubled. This requires an explanation, especially in a year like 1974, when incomes and private voluntary saving slowed down considerably (the nominal growth was about 9 percent). The striking increase in provident fund receipts (about 40 percent higher than the increase in the Consumer Price Index) apparently was due mainly to two factors which could have led to an extensive shift from the various forms of financial savings to savings through social insurance funds.

(1) The fear that a tax might be imposed on linkage increments and that social insurance fund savings would be less vulnerable than other types of linked savings (for example, a direct investment in bonds);

(2) The increase in tax benefits allowed in August 1973, which greatly increased the relative attraction of this type of saving. The ceiling for deductible contributions to social insurance funds (and to insurance companies) was increased from IL 1,500 to IL 2,100 for the self-employed, and from IL 900 to IL 1,500 for employees who do not receive pension or provident payments at the expense of their employers. The ceiling for the 25 percent credit on income tax was increased from IL 900 to IL 1,500. These changes raised the ceilings by about 50 to 60 percent.

In contrast to the provident funds, contributions to the severance pay funds increased rather sluggishly (about 32 percent)—not enough to keep up with the rise in the Consumer Price Index (about 40 percent). This was presumably the result of liquidity difficulties and the rising cost of credit, which apparently tempted some employers to delay their contributions.

As to savings withdrawals, whereas pension fund payments moved up to about the same extent as the general price level in 1974 (annual average), provident fund payments increased by a staggering 112 percent. This raises doubts about the effectiveness of provident funds for long-term saving—the purpose for which they were established. The provident funds paid out IL 260 million—an especially high figure in view of the limited scope and recent origin of these schemes. It is probable that in 1974, an increasing share of the contributions was temporary (rather than long-term saving) to take advantage of tax benefits. (At the end of ten years, it is possible to withdraw all provident fund contributions made during the period, including the contribution made in the tenth year.) We have no reliable data on the composition of deposits, so this assumption cannot be tested. Suffice it to mention that in February 1975, the public sector ruled that an annual deposit in excess of IL 9,600 had to be frozen for ten years in order to gain the tax benefit.

Withdrawals from the severance pay funds increased approximately 85 percent, with the bulk of the sum accounted for by employers. This is consistent with the developments in gross deposits explained above. Despite rapidly rising prices, the funds' net receipts virtually did not increase.

2. Use of funds

Since allocation of the resources mobilized by the funds is dictated by the aforementioned regulations, they are used mainly to purchase bonds. During the last two years (as in the past), about 80 percent of the funds' net accumulation of savings has been invested in the securities market—chiefly in bonds of financial institutions. To a more moderate extent, the funds have acquired Government bonds, as well as shares of banking institutions (see Table XVIII-12).

The restriction imposed in the middle of 1974, prohibiting the funds from

Table XVIII-12

CAPITAL MARKET USES OF SOCIAL INSURANCE FUND SAVINGS, 1973-74

(IL million)

	Payments		Receipts		Payments surplus	
	1973	1974	1973	1974	1973	1974
Purchase of original-issue securities and redemptions, by issuer	1,612.7	2,335.5	726.8	1,121.1	885.9	1,214.4
Government	77.1	100.0	44.5	56.7	32.6	43.3
Financial institutions	1,400.6	2,131.3	555.9	916.7	844.7	1,214.6
Banks	64.2	76.8	8.6	8.8	55.6	68.0
Other	70.8	27.4	117.8	138.9	-47.0	-111.5
Secondary market security transactions	351.8	304.5	509.5	314.3	-157.7	-9.8
Deposits (net of redemptions)					10.6	51.8
Subtotal (Table XVIII-10)					738.8	1,256.4
Long- and medium-term credit granted and loan repayments	216.1	307.4	157.0	199.4		
Households	186.9	247.4	151.7	174.4		
Business	12.3	28.6	3.2	15.0		
Local authorities	16.9	31.4	2.1	10.0		

reselling any of the securities in their portfolios to the public, reduced the average annual volume of the sector's security sales only slightly. In addition to sales made before the restriction, the funds were permitted to sell securities every time withdrawals exceeded deposits and redemptions. Nevertheless, the sector's sales in the secondary market dropped from IL 158 million in 1973 to only IL 10 million in 1974. In recent years, the funds have tended to concentrate their investments in bonds issued by financial institutions, at the expense of bonds issued by other bodies (chiefly the national institutions). As a result, net redemptions have exceeded purchases of bonds from the other bodies (see Table XVIII-12). Quite naturally, the largest funds tend to acquire bonds of institutions belonging to their own financial concerns.

The sector also was moderately active in granting medium- and long-term credit, especially to households (see Table XVIII-12). This credit to households, part of which was indirectly linked, increased by 33 percent to approximately IL 250 million.

Short-term uses increased from IL 14 million in 1973 to IL 62 million in 1974—a development that must be viewed in conjunction with money market trends this year. These uses consisted chiefly of short-term loans to employers; from the standpoint of the funds, they were made at the expense of linked investments in bonds. The share of securities in the net savings increment declined from 82 percent in 1973 to 80 percent in 1974, despite the fact that the rapid inflation alone should have prompted the funds to increase their linked cover. This development was at least partly a result of the tension in the credit market and the competition among funds for business.

Because of the much larger volume of funds mobilized this year and the accelerating inflation, the sector's revalued combined balance sheet increased 78 percent to IL 18,200 million at the end of 1974. This balance sheet, whose assets are chiefly securities and whose liabilities are chiefly savings funds, emphasizes that the social insurance funds are primary financial intermediaries.

2. INSURANCE COMPANIES

(a) *Structure of insurance companies and nature of their activities*

The insurance industry in Israel consists of Israeli companies (about 30), branches of foreign firms (approximately 40), and Lloyd's agents allowed to operate in Israel. The lion's share of the life insurance business is handled by Israeli companies, which, with the aid of the Treasury, offer insurance policies linked to the Consumer Price Index. Israeli companies also account for 80 percent of the general insurance business.

The volume of life insurance transactions is lower than that of general insurance, but life insurance is an incomparably more important source of funds. The life insurance reserve (the accumulated saving of households through the insurance companies) was five times larger than that of the general insurance reserve (see balance sheet). This is because general insurance generates short-term assets, while life insurance generates long-term assets.

Insurance companies in the life insurance business are (like the social insurance funds) primary financial intermediaries; they mobilize funds directly from households, and invest the proceeds in Government-approved long-term securities (Government and Israel Electric Corporation bonds) issued especially for them with maturities of up to 30 years or more.

The benefits to savers in social insurance funds also apply to life insurance policyholders. In effect, allowing for the changes entailed by the terms and nature of life insurance business, most of the restrictions in force on the manner in which insurance funds may be invested also apply to the life insurance branch. The insurance companies must hold assets with matching terms against their liabilities on account of linked insurance,¹⁷ with the exception of (1) 5 percent which they may hold in cash; (2) their approved outstanding premiums; and (3) other current assets.

Of the assets subject to linkage, insurance companies may grant loans to policyholders up to the cash surrender value of their policies without any limitation; of the balance, they may invest up to 20 percent in securities approved by the Commissioner of Insurance and up to 20 percent in linked loans against bank guarantees. The remainder (60 percent) must be invested in Government or Government-guaranteed bonds. Because of the relative profitability of this type of investment, the companies actually purchased more bonds than they are legally required.

(b) Income and outgo of the life insurance branch

Life insurance premium receipts increased 56 percent to IL 442 million. This real growth of about 12 percent must be credited more to the public's increased insurance consciousness after the war than to a desire to put more savings into insurance. Saving in the form of insurance is the least liquid of a wide range of saving schemes available, and its real yield is not high enough to compensate for this low liquidity. Without the regulation that linked life insurance must contain a minimum saving element, life insurance savings would have dropped drastically (or, alternatively, the

¹⁷The regulations pertaining to unlinked insurance are the same in principle, but relatively easier.

Table XVIII-13

**INCOME, OUTGO, AND ACCUMULATION OF LIFE INSURANCE
COMPANIES IN ISRAEL,^a 1972-74**

(IL million)

	1972	1973 ^b	1974 ^c
1. Income			
Premiums	207.5	286.4	442.0
Interest	41.9	61.0	100.0
Total	249.4	347.4	542.0
2. Outgo			
Benefits to policyholders	67.9	105.9	148.0
Agents' commissions	29.0	39.4	57.0
Other operating expenses	31.0	40.4	57.9
Gross profit ^d	15.3	9.9	57.0
Total	143.2	195.6	319.9
3. Surplus of income over outgo (1-2)	106.2	151.8	222.1
4. Income from investment of life insurance funds	49.2	111.2	317.5
5. Annual accumulation (growth of the life insurance reserves — (3+4)	155.4	263.0	539.6

^a Israeli and foreign insurance companies operating in Israel: before deducting reinsurance abroad.

^b Revised data.

^c Estimate.

^d Including profits of reinsurers abroad.

SOURCE: Central Bureau of Statistics.

return would have risen significantly).

The increasingly rapid inflation in 1974 was only partly reflected in receipts of linked interest premiums (up 64 percent, as against 45 percent in 1973). However, it was fully expressed in capital gains. The greatest part of these came from insurance fund investments, which went up from IL 110 million in 1973 to IL 317 million.

As competition for additional business increased, the companies did not reduce premiums (as in the past), but increased agents' commissions—which went up 44 percent to IL 57 million. Most commissions are for new policies.

Net accumulation in the life insurance branch, including the appreciation of investments, totalled IL 540 million this year—an increase of 105 percent in nominal terms and 47 percent in real terms compared with 1973.

Net acquisitions¹⁸ of Government and Israel Electric Corporation bonds came to IL 180 million, accounting for 80 percent of the surplus receipts over expenditures (see Table XVIII-13).

(c) *Income and outgo of the general insurance branch*

Premium receipts from general insurance rose about 32 percent—a very moderate increase in view of the 40 percent increase in the Consumer Price Index. Even if motor vehicle insurance (which accounts for about 40 percent of general insurance business) is excluded—not all car owners increased their motor vehicle insurance coverage in line with post-devaluation values—general insurance still grew only 31 percent. This means that the level of coverage of economic activity may have dropped in 1974,¹⁹ a development of some significance, as this was the first time

Table XVIII-14
GENERAL INSURANCE PREMIUM RECEIPTS,^a 1972-74

	(IL million)		
	1972	1973	1974 ^b
Total general premium receipts	676.4	888.8	1,172.6
Motor vehicle insurance	251.4	355.4	474.0
Other insurance	425.0	533.4	698.6
Percent annual increase in premium receipts			
Total general insurance	36.5	31.4	31.9
Motor vehicle insurance	49.6	41.4	33.4
Other insurance	29.7	25.5	31.0

^a Of Israeli and foreign companies and Lloyd's agents. Includes registration fees and marine insurance; excludes reinsurance in Israel.

^b Estimate.

SOURCE: Central Bureau of Statistics.

¹⁸ Net of capital redemptions, interest and linkage.

¹⁹ Whether it actually dropped is not quite clear, since the rise in the price of insurance transactions was lower than the rise in the Consumer Price Index.

this happened since 1967. However, this finding must be treated with caution, since the Central Bureau of Statistics' estimates of general insurance volume have sometimes been downward biased.

(d) *Balance sheet of Israeli companies*

The combined balance sheet of Israeli insurance companies expanded 45 percent in 1974 to IL 2,970 million. This is a relatively low rate if we consider the steeply rising prices and the rapidly accelerating activity in life insurance. The low rate is related to the fact that assets and liabilities were not brought up to date to the end of the year.

Securities, despite the delay in revaluation, form about 55 percent of the total assets, and insurance funds (including pending claims) form about 75 percent of total liabilities; thus, insurance companies are basically primary financial intermediaries, although to a lesser degree than the social insurance funds. Still, because of the nature of their activities and the competition between them, their volume of short-term assets is larger than in the social insurance funds. "Other loans", "Outstanding premiums", and "Sundry debtors" (see Table XVIII-15) account for more than 30 percent of total assets.

Notable developments are the increased weight of linked securities in total assets (about 55 percent, against 48 percent in 1973), and the increased weight of the life insurance fund in total liabilities (45 percent, against 41 percent in 1973).

3. MUTUAL FUNDS

These institutions issue participation certificates (redeemable on demand) to households, and invest all of the proceeds (except for a meagre proportion kept in liquid assets) in bonds and shares. Of the 15 institutions, five (the veteran funds) invest most of their resources in shares, seven concentrate on bonds, and the remaining three invest in both shares and bonds.

In 1974, the bond funds increased their net issues fourfold to IL 1,000 million (against IL 240 million in 1973 and about IL 50 million in previous years). This unprecedented growth was not caused by an expansion of voluntary saving, but by a drastic change in the composition of households' assets. Instead of holding bonds directly, households shifted to institutional saving schemes because of the fear that a tax might be imposed on linkage gains. Approximately 75 to 80 percent of the net issues were concentrated in the first half of the year; in August, September and October, net issues were very slight (about IL 40 million). In November—when the Israeli currency was devalued—net issues jumped again. These fluctuations in net

Table XVIII-15

ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES, 1972-74

	IL million			Percent		
	1972	1973 ^a	1974 ^b	1972	1973	1974
Assets						
Government or government-guaranteed bonds	652.5	933.5	1,540.0	44.1	45.6	51.9
Other securities	38.4	53.3	86.0	2.6	2.6	2.8
Loans on policies	29.1	34.0	35.4	2.0	1.7	1.2
Other loans	143.3	259.6	340.0	9.7	12.7	11.5
Long-term deposits	44.9	66.7	65.0	3.0	3.3	2.2
Real estate and investment in subsidiaries	84.7	104.5	149.6	5.7	5.1	5.0
Outstanding premiums	166.0	241.9	335.0	11.2	11.8	11.3
Sundry debtors	175.0	184.2	215.0	11.8	9.0	7.2
Cash and demand deposits	144.6	170.0	204.0	9.9	8.2	6.9
Total assets	1,478.5	2,047.7	2,970.0	100.0	100.0	100.0
Liabilities						
Paid-up share capital	81.3	96.4	110.0	5.5	4.7	3.7
General and other reserves	75.7	109.5	142.3	5.1	5.3	4.7
Life insurance reserve (less reinsurance)	598.3	848.9	1,345.0	40.5	41.5	45.3
General insurance reserve (less reinsurance)	152.6	190.9	252.0	10.3	9.3	8.5
Extraordinary risks reserve	64.5	76.0	101.3	4.4	3.7	3.4
Deposits of reinsurers	118.9	135.4	145.0	8.0	6.6	4.9
Pending and approved claims	225.5	366.0	542.4	15.3	17.9	18.3
Current liabilities	161.7	224.6	332.0	10.9	11.0	11.2
Total liabilities	1,478.5	2,047.7	2,970.0	100.0	100.0	100.0

^a Revised data.^b Estimate.

SOURCE: Central Bureau of Statistics.

Table XVIII-16

SOURCES AND USES OF FUNDS — MUTUAL FUNDS, 1973-74

(IL million)

Sources	1973	1974	Uses	1973	1974
Shares sold, at issue price	276.6	1,247.0	Purchases of original-issue securities	87.3	160.1
Shares redeemed, at redemption price	36.2	247.2	Securities redeemed (principal, interest, and linkage differentials)	47.1	114.6
Net issue proceeds	240.4	999.8	Net purchases of original-issue securities	40.2	45.5
			Net purchases in secondary market	122.4	779.2
			Expenses, taxes, dividends	69.2	141.3
			Change in liquid means	8.6	33.8
Total sources	240.4	999.8	Total uses	240.4	999.8

issues corresponded more or less (with a delay of about one month) to the fluctuations in the Consumer Price Index; it is probable that, as prices rose, fears of a tax on linkage gains increased.

Since the relative inferiority of investment in shares intensified, the activity of the share funds remained at a standstill; net issues of the mixed funds (shares and bonds) amounted to only IL 5 million. Nevertheless, these funds gave their clients a return which was not much lower than those of most bond funds.

In contrast to the respectable performance of the mutual funds in the mobilizing of resources from the public, their financing of the Government and the various sectors of the economy was strikingly modest compared to the contributions of the other primary financial intermediaries. Net acquisitions²⁰ at source by the mutual funds (mostly in Government and financial institutions bonds) were only IL 46 million—while their net acquisitions in the secondary market²¹ reached IL 780 million. These acquisitions consisted mainly of securities with quite short maturities—apparently because the funds' managers (who must redeem certificates on demand) wanted to reduce the risk involved in their portfolio securities. (The longer the maturity of the bonds, the more sharply their prices fluctuate.) Indeed,

²⁰ Less capital redemptions, interest and linkage.

²¹ Acquisitions in the secondary market at cost, less sales in the secondary market at realization prices.

redemption of certificates (after the offsetting of buy and sale orders by the fund managers) reached IL 250 million, or 20 percent of the gross issues.

The mutual funds' massive acquisitions in the secondary market probably supported the bond rates and helped check the mounting yield on redemption.

Although the investment portfolios of the bond funds are relatively liquid, the participation certificates have a lower liquidity because of the gap between the issue price and the redemption price (a gap which is fixed by the administrators of the funds).

As a result of the increased mobilization of savings and the significant rise in prices, the market prices of the funds' portfolios increased about 165 percent to IL 2,365 million (after distribution of IL 120 million in dividends).

4. FINANCIAL INSTITUTIONS

(a) Structure of the sector and nature of its activity

This sector comprises 78 intermediaries which specialize in financing the various sectors of the economy, the Government, the local authorities and households. They fall into four principal classifications:

(1) The mortgage banks (17 in number) specialize in financing buyers of private and public housing. They also deal in short- and medium-term financing of contractors and building companies, and supply long-term loans to hotels.

(2) The development banks (28) specialize in financing industry, agriculture, tourism and the local authorities. A small proportion of the group's activity consists of short-term credit to agriculture and industry.

(3) The investment companies (19) issue bonds to raise funds from primary financial intermediaries, and directly and indirectly (through banking institutions) finance the local authorities and the government.

(4) The household finance companies (14) specialize in medium- and long-term supplementary credit to households for the purchase of housing and durable goods.

The financial institutions are secondary financial intermediaries. They mobilize financial resources (excluding loan repayment receipts) from other financial intermediaries, and allocate them to their final purposes—financing the various sectors of the economy, the local authorities and the real demand of households.

The Government's control over most of the sector's activity is detailed exhaustively in Part I of this chapter. Here we shall merely note that part (a relatively small part) of the financial institutions' lending operations consists of loans granted at the sector's own discretion. The financial resources for the autonomous activity are composed of funds from the private sector (the volume of which depends

largely on monetary developments), funds which the Government allows the institutions to raise abroad for their own free uses and proceeds of the sector's bond issues in excess of the proportion which must be deposited with the Accountant General or earmarked for Government-directed loans. Although these resources may be used freely by the institutions, they enjoy partial linkage insurance from the Treasury (at unreal premiums).

(b) *Flow of funds*

The resources available to the financial institutions for onlending to the various sectors of the economy, households and local authorities increased substantially in 1974, rising 56 percent to approximately IL 5,780 million.

Excluding loan repayment receipts (see Table XVIII-17), whose level was dictated by the level of past activity, the overwhelming proportion of net resources came from social insurance funds, insurance companies, savings schemes and mutual

Table XVIII-17

SOURCES AND USES OF FINANCIAL INSTITUTION FUNDS, 1973-74
(IL million)

Sources	1973	1974	Uses	1973	1974
Net household savings ^a	62.3	172.3	Medium- and long-term		
Loan repayments	1,704.5	2,484.2	credit granted	2,790.0	4,155.6
Households	449.1	578.9	Households	879.7	1,614.2
Business	963.1	1,330.3	Business	1,524.0	1,910.0
Local authorities	292.3	575.0	Local authorities	386.3	631.4
Net transfers ^b	1,913.9	3,053.4	Net transfers ^c	699.6	1,177.9
Social insurance funds			Government	618.5	872.8
and insurance			Banking institutions	81.1	305.1
companies	860.1	1,270.0	Net change in short-term		
Approved saving			uses ^d	-127.7	205.5
schemes and mutual			Surplus of expenditure		
funds	688.7	1,600.1	over income, incl.		
Other	365.1	183.3	taxes and dividends	246.9	369.5
Net sale of securities in			Change in cash and		
the secondary market	29.8	69.9	demand deposits	101.7	-128.7
Total sources	3,710.5	5,779.8	Total uses	3,710.5	5,779.8

NOTE: See general note to Table XVIII-10.

^a Net of withdrawals.

^b This item consists predominantly of net purchases of securities.

^c This item consists predominantly of net loans and deposits.

^d The increase in outstanding short-term assets, less the increase in outstanding short-term liabilities.

funds—mainly through new bond issues. Net transfers from the institutional system increased 85 percent over 1973 to reach IL 2,870 million. In contrast, net resources obtained from the private sector through direct bond issues declined drastically, as reflected in Table XVIII-17: transfers of net resources from others declined from IL 365 million in 1973 to IL 183 million—although these include deposits for loans to contractors and building companies, which increased substantially in 1974.

Repayment of loans rose 46 percent to IL 2,484 million. Repayments from households and private businesses (most of whose loans were unlinked) were up 29 and 38 percent respectively; repayments from local authorities (most of whose loans were linked to the Consumer Price Index) doubled.

There were significant changes in the allocation of resources compared with 1973: (1) an unprecedented 83 percent increase in loans to households; a 63 percent increase in loans to local authorities (apparently because of the burden of repayment of linked debts); and a rather slow 25 percent increase in loans to private business. (2) An increase in net short-term uses of IL 205 million, compared to a decline of IL 128 million in 1973 (apparently because of heavy pressure on the sector this year, which led it to divert medium- and long-term funds to short-term uses, despite the steep rise in prices). (3) An increase in net absorption by the banks from IL 81 million in 1973 to IL 305 million (probably because of the liquidity difficulties experienced by commercial banks most of the year).

(c) Developments by type of institution

1. Development banks

Resources expanded 41 percent to IL 1,877 million—a relatively moderate advance, since it exceeded by only 2 or 3 percent the rise in the price index of investments in the various sectors of the economy (excluding residential construction). Government and overseas contributions increased, while funds raised through the net issue of new bonds and shares declined.

Gross medium- and long-term uses rose only 23 percent—a very sluggish growth rate compared to the rise in price of investments. However, net short-term uses expanded considerably—from a decline of IL 164 million in 1973 to a growth of IL 174 million in 1974.

From these data, plus the fact that restrictions on the issuing of bonds did not effectively limit the mobilization of resources by the development banks, it may be concluded that the real deceleration in the expansion of medium- and long-term financing was dictated by demand factors. (As far as “soft” credit is concerned, the reference is, of course, only to the demand associated with the rates of loan capital to

which the enterprises are entitled—which are a fixed proportion of the investment value.)

2. Mortgage banks

Mobilization of resources by the mortgage banks increased conspicuously by 63 percent to IL 1,800 million. The most notable structural changes in the banks' resources were an enormous decline in net resources from overseas (in the past, this component financed the autonomous activity of the group); a significant increase in net issue of bonds and a doubling of the private sector's contribution.

The Government's net direct contribution went up only 17 percent to a modest IL 199 million. However, it should be stressed that the resources from households (Saving-for-Building Scheme) and from new bond issues are supplied indirectly by the Government and these made possible the swift expansion of the mortgage banks' resources. The contribution of these indirect items, together with the Government's direct contribution, amounted to IL 678 million (compared with IL 247 million in 1973).

At the same time, there was a relatively substantial increase (approximately IL 50 million) in net resources supplied by private business, which reached IL 154 million. This included deposits of the Israel State Lottery, which were used chiefly to finance local authorities, and deposits of contractors and building companies (which increased their contribution in an effort to stimulate sales).

A breakdown of the medium- and long-term gross credit provided to households into its directed and nondirected components strengthens the conclusion (also on the side of the uses) that it was the public sector that made possible the amazing acceleration of credit to buyers of private and public housing (86 percent).

3. Investment companies

Funds raised by the investment companies increased 59 percent to IL 2,584 million. As in the past, this was collected mostly through the issue of new bonds and shares to the social insurance funds and the savings schemes. The overwhelming proportion was transferred to the Government and to the banking institutions, which mobilize funds for their affiliated financial concerns. (The lion's share of these funds flows back to the financial institutions for onlending to the various sectors of the economy, households, and local authorities.)

Together with its central function of supplying credit to the Government and other institutions, the investment companies use part of their resources for lending to businesses and local authorities, as well as for the purchase of securities. In 1974 the

amount diverted to the acquisition of securities came to a respectable IL 194 million (IL 41 million in 1973), while credit was stepped up by an appreciable 78 percent. Since the bulk of the credit is granted on index-linkage terms, the flow of repayments is especially sensitive to the rate of increase in consumer prices.

4. Household finance companies

This group, the smallest in the sector, raised IL 145 million (approximately 40 percent more than in the previous year). It draws its resources chiefly from the Government and the national institutions, and provides most of its credit at soft terms to State employees and new immigrants. Since most of the credit is medium-term, repayments form a respectable part of the group's resources—although the loans are not linked and the flow of repayments does not increase with the rise in prices.

(d) Assets and liabilities

The combined balance sheet of the financial institutions increased 62 percent to IL 38,700 million; approximately one-quarter of this is the Government's debt to the sector, mainly on account of deposits of bond issue proceeds with the Treasury (see Table XVIII-18).

The sector's liabilities are composed chiefly of medium- and long-term obligations, with the weight of equity capital (which has been in a downtrend for some years now) being quite low (6.4 percent in 1974). However, the institutions' operations consist largely of providing loans placed at their disposal by others, at the latter's responsibility. In addition, more than one-quarter of the sector's liabilities is covered by assets with the Treasury.

The sector's liabilities show a continued increase in the weight of bonds (60 percent at the end of 1974), and a decline in the weight of Government deposits earmarked for loans. But this, of course, does not indicate any weakening of the sector's dependency on the public sector.

A parallel change in the composition of assets was a continued decline in the weight of loans from Government deposits, and an increase in the weight of loans from autonomous (and other) sources. The weight of securities in total assets continued to drop; by the end of 1974 it came to 2.6 percent only.

Table XVIII-18

ASSETS AND LIABILITIES OF FINANCIAL INSTITUTIONS, 1972-74

	IL million			Percent		
	1972	1973	1974	1972	1973	1974
Assets						
Cash and bank deposits	235.9	374.3	556.0	1.4	1.6	1.4
Credit to the public from govt. deposits	3,494.0	4,049.4	5,237.7	20.4	16.9	13.5
Credit to the public from own means and ear- marked deposits	8,804.7	12,864.1	21,499.3	51.4	53.7	55.6
Securities	742.3	866.5	1,019.9	4.3	3.6	2.6
Immovable property	32.7	29.4	29.5	0.2	0.2	0.1
Deposits with the Accountant General	3,806.9	5,757.1	10,339.2	22.3	24.0	26.8
Total	17,116.5	23,940.8	38,681.6	100.0	100.0	100.0
Liabilities and capital						
Equity capital	1,754.8	2,118.5	2,493.7	10.3	8.8	6.4
Bonds	8,424.3	12,861.6	23,331.1	49.1	53.7	60.3
Govt. deposits earmarked for loans	3,501.4	4,059.6	5,207.2	20.5	17.0	13.5
Other deposits and loans	3,333.4	4,687.9	7,400.3	19.5	19.6	19.1
Demand deposits	20.6	36.2	42.9	0.1	0.2	0.1
Other accounts	82.0	177.0	206.4	0.5	0.7	0.6
Total	17,116.5	23,940.8	38,681.6	100.0	100.0	100.0

NOTE: Since the definition of the financial institution sector has been broadened, the data presented in this table are not comparable with those in previous years.