CHAPTER XVIII

THE SECURITIES MARKET

1. Main Developments

Net new issues of bonds were up strongly in 1971, when the figure (excluding compulsory loans) reached IL 1,298 million, compared with IL 682 million the year before. Most of the increase was in long-term and option-type bonds, while those traded in foreign currency rose only slightly. Adding net Government receipts from compulsory loans brings the total up to IL 2,276 million, a gain of 84 percent in nominal terms and of 64 percent in real terms over the previous year.

The accelerated growth of long-term and option-type[1] issues is attributable to several factors. In the case of long-term bonds, which are taken up mainly by social insurance funds and insurance companies, the reason was their higher rate of accumulation and some advancing of purchases on account of 1972 (see Chapter XVII). As to option-type loans (which are acquired chiefly by households, either directly or indirectly), the gain can be ascribed to the smaller distribution of compulsory loan certificates in 1971,[2] the big increase in the economy's liquidity, and expectations of a general rise in prices following the devaluation of the Israeli pound in August. The last two developments stimulated demand for financial assets, particularly those linked to the cost-of-living index.

Turnover in the secondary bond market was, at IL 368 million, 66 percent higher than in 1970 and accounted for 59 percent of total Stock Exchange trade. However, in the year reviewed it was the share market that captured the limelight, as reflected in the strong rise of volume and quotations. The growth of bond turnover in the secondary market was due to portfolio adjustments in the wake of the devaluation and to the heavier demand for value-linked assets which, besides heightening activity in the second-

1. Option-type loans permit the investor to choose, upon maturity, between a high rate of interest without linkage of the principal and interest, and a lower rate with the principal and interest linked to the consumer price index.
2. This reduced the offer of this type of paper in the secondary market, as some of the households do not make a practice of holding financial assets and dispose of them in the secondary market soon after receipt of the certificates.

ary bond market, led to an increase in new issues. The yield to maturity on compulsory loan certificates acquired in the secondary market continued to decline during the year and reached the yield level for original-issue bonds acquired voluntarily. This precluded the possibility, which had existed in the past, of reaping capital gains on compulsory loan certificates bought in the secondary market, and induced investors either to purchase bonds at source or to turn to the share market.

Short-Term Loan holdings of the public were up IL 157 million in 1971, as opposed to IL 93 million the year before, while the net amount absorbed (i.e. less interest paid and dealers' commissions) came to IL 89 million. The most striking development here was the stronger propensity to purchase shorter series at the expense of longer series, thus transforming this paper into more of a short-term debt instrument. This development occurred against the background of sharply advancing prices in the economy and the existence of alternative linked medium- and long-term investment outlets and the absence of such alternatives in the short run.

The flotation of equity issues by companies registered on the Stock Exchange was renewed in 1971, and totalled IL 52.8 million. Nearly all of this sum – IL 48.3 million – represented issues of financial companies intended to finance their expanded business operations (see section 4), while the remaining IL 4.5 million was issued by an industrial company, in its initial attempt to raise funds through the Stock Exchange. Although this represented a departure from the fairly protracted trend of almost complete absence of new issues, particularly of shares offered to the public, the amount involved was rather modest, so that it is premature to claim that the share market is becoming a major factor in mobilizing new investment capital. In fact, in the light of the notable rebound of the secondary share market (see below), equity issues might have been expected to advance more than they actually did, and the fact that there was not a greater revival suggests that it was not conditions in the secondary market that precluded the primary market from becoming an important instrument for raising investment capital.

In 1971 share turnover on the secondary market doubled, and the monthly index of ordinary share prices jumped 23 percent, after dipping 11 percent in the previous year. The rally got under way in the first half of the year and picked up momentum after the August devaluation, with the fuel and oil, industrial and commercial, and land and development share groups leading the way; the banking, finance, and insurance group and investment companies began to perk up at a later date and rose more slowly over the year as a whole.

A number of factors combined to spark the comeback of the equity market after several consecutive years of dismal performance. The most significant were as follows:

(a) The strong monetary expansion generated liquidity surpluses in the banks and enabled them to finance speculative transactions in financial assets.

(b) The yield of compulsory loans traded in the secondary market slipped to the level generally prevailing in this market, erasing the chances for quick capital gains on bond holdings.

(c) The devaluation of the Israeli pound aroused expectations of a vigorous bullish upswing in the share market, as happened after the 1962 devaluation.

(d) The purchase of shares became more worthwhile because of the decline in the price-earnings ratio, reflecting the brighter hopes of making a profit on equity investment.

(e) Apparently there was a somewhat more cheerful outlook on the entire matter of equity investment.

It is of interest to note the development of devaluation expectations over the year. During the first seven months the three conventional indicators (see section 7) pointed to a subsiding of such expectations, and this accounted for investors' behavior during that period. The devaluation of August 22 came as a surprise to most investors in the capital and money markets. Subsequently they adjusted their portfolios, mainly in order to realize devaluation gains and to switch to assets value-linked to the cost-of-living index in anticipation of a general price rise in the economy.

The balance of foreign currency securities held by Israeli residents reached some $325 million; the proportion of securities listed on foreign exchanges is on the downswing and stood at only 20 percent by year's end. In 1971 Israeli institutions (including Hollis, an overseas subsidiary of the Jewish Agency) sold $50 million worth of foreign currency securities, most of which were purchased by Israelis.

After devaluation the agio on Natad dollars[3] hovered close to its minimum level, i.e. the official rate of exchange. This indicates that demand for the Natad dollar in the postdevaluation period trailed behind supply even at this price.

2. The Nature and Scope of the Securities Market

The securities market, as defined in this chapter, may be subdivided: the new issue or primary market, where securities issued by companies wishing to raise capital are sold to the public and institutional investors; and the secondary market, where trading in the stock of existing issues is conducted. The characteristic feature of the new issue market is the absence, in general, of prior contact between the issuer and the saver – a contact made only at the Stock Exchange and by virtue of its existence. For the individual investing in securities, the distinction between the two markets lacks significance; it has importance primarily for analytical purposes and for understanding the role played by the capital market.

For a security issue to be included in the primary market, it must be an offering to the general public, as distinguished from a prior arrangement between whoever is raising the capital and a group of private individuals who agree to invest in the enterprise outside the framework of an organized market. However, in applying this definition problems arise of borderline situations which do not fall clearly into one category or the other.[4] In

3. For a definition of Natad dollars see section 8.
4. There is no precise definition of the term "an offering to the general public". The most conspicuous borderline case in the Israeli economy is the 17-20 year bonds purchased by social insurance funds, mostly without any resort to an organized securities market. In this chapter both these issues and those sold to insurance companies are treated as falling within the compass of the market.

this chapter the "primary market" will include every issue offered by a prospectus[5] and every Government or Jewish Agency issue sold to the general public.[6]

In the secondary market trade takes place in securities that were issued in the past either within or outside the framework of the primary market. Such trade allows holders of securities to dispose of them quickly without loss, and thus enhances the willingness of savers to turn to the securities market and to accept a lower return at the time of purchase. In Israel the secondary market is identified principally with the Tel Aviv Stock Exchange, where trade is conducted by brokers after matching buy and sell orders.

Relative to the total number of firms operating in Israel, those whose shares are traded on the Stock Exchange are few, and are concentrated primarily in the financial sector. Hence an analysis of their performance cannot be regarded as very indicative of the general economic situation or the relationship between developments in the economy and the movement of equity prices on the Exchange.[7] Of the 85 stocks traded on the Exchange, 44 are in the financial group, 12 in land and development, 24 in industry and commerce, and five in other groups.

The number of bond issues traded in the secondary market far exceeds the number of stocks, but in view of the control (both direct and indirect) exercised by the Government over bond issues and the lack of private issues with dissimilar returns and risk element, there are few surprises in this market. Consequently its placidness is ruffled only when compulsory loans are listed on the Exchange. Because of the large volume of these loans and the fact that they are purchased at source also by persons who have no interest in holding financial assets in general or of bonds of this type in particular, their listing on the Exchange immediately sparks off a livelier and more interesting trade than that in voluntary loans.

As already noted, when the forced loans (Absorption, Compulsory Savings, and Defense) levied by the Government at various times are eventually listed on the Stock Exchange, they form a part – and generally a sizable one – of the secondary market. As a rule, several years elapse between the collection of the loans and the actual delivery of the certificates. When examining their contribution to the mobilization of capital or the siphoning off of purchasing power, if they are regarded as a tax,[8] it is the date of their collection that is important; while as regards their direct influence on the securities market (as opposed to the indirect influence they exert by reducing disposable private income and thus limiting voluntary savings and bond purchases), it is the actual date of distribution that counts. Since some of the recipients of compulsory loan certificates do

5. The Securities Law, 5728-1968, section 15 (a) states, "A person shall not offer securities to the public otherwise than under a prospectus the publication of which has been permitted by the Authority." The Government and Jewish Agency are exempt from this provision.
6. The various compulsory loans levied on the public by the Government are not regarded as part of the primary market, although they are a form of raising capital in the economy and the loan certificates become part of the secondary market when delivered to the public and listed on the Stock Exchange.
7. To be sure, the profitability of the financial institutions is connected with general economic developments, but only indirectly.
8. For a detailed discussion of this see Bank of Israel, *Annual Report 1970*, p. 394.

not make a practice of holding financial assets of this type, they dispose of them on the secondary market, swelling the supply of such paper. This in turn depresses the price, pushes up the yield to maturity, and shifts some of the demand for bonds from the primary to the secondary market. Therefore, in discussing the volume of new bond issues account must also be taken of the value of compulsory loan certificates distributed during the year, as this somewhat dims the chances for floating new issues.

Among the bond issues sold on the Exchange are some that are denominated and traded in foreign currency (usually in dollars, but occasionally also in various European currencies). These issues are floated by various Israeli companies and institutions, with the encouragement of the Treasury, in order to satisfy the demand of Tamam and Natad account owners for low-risk securities denominated in foreign currency while avoiding the contraction of foreign exchange reserves because of purchases of foreign securities.

3. The Bond Market

(a) *New issues*

The year reviewed saw a faster rise in bond issues, both those denominated in Israeli currency and those in foreign currency (excluding compulsory loans). Sales grossed IL 1,564 million, as against IL 936 million in 1970, while the net figure (sales less redemption of principal) swelled even more, from IL 682 million to IL 1,298 million. Israeli currency bonds alone jumped from IL 562 million to IL 1,140 million (see Table XVIII-1).[9]

Since most of the new issues of option-type bonds and those denominated in foreign currency are listed on the Exchange, there was a big increase in total bond listings, even after allowing for the increment due to the devaluation (see Table XVIII-8).

A breakdown of the Israeli currency bonds shows that the notable gain was paced by long-term bonds, the Insurance Companies Loan,[10] and option-type issues. In the case of long-term bonds, the growth resulted from the increased accumulation and the advancing of purchases by social insurance funds and insurance companies, which are almost the sole customers for this type of paper (see Chapter XVII). The factors behind the rise in option-type loans – from IL 77 million in 1970 to IL 295 million in 1971 – are more complicated. The increase in these issues – which are sold mainly to households – took place at a time when there was no change in the nominal level of gross private saving (net of compulsory loans) in comparison with the previous year. One explanation is to be found in the decline of about IL 180 million in the net distribution of compulsory loan certificates, which led to some shifting of demand to the primary market.[11] Another cause was the large external infusion (i.e. the increase in the economy's liquidity) during the year, which resulted *inter alia* in heavy purchases of financial assets, particularly

9. In analyzing the flow of funds through the securities market, interest and linkage differential payments during the year must be deducted from the net amount of capital raised. In 1971 proceeds to issuers reached IL 887 million, as contrasted with IL 327 million the year before.
10. For details see p. 451.
11. For a more detailed explanation see section 2.

Table XVIII–1
DOMESTIC SECURITY ISSUES,[a] 1970-71[b]
(IL million)

	1970					1971					
	Gross issue	Redemption of principal	Net issue	Redemption of interest & linkage differentials	Total proceeds	Gross issue	Redemption of principal	Net issue	Redemption of interest & linkage differentials	Total proceeds	Increase or decrease (–) in net issues
Regular bonds											
Long-term	522.5	89.0	433.5	200.4	233.1	898.6	118.0	780.6	264.9	515.7	347.1
Government loans	3.3	12.7	–9.4	38.4	–47.8	30.7	13.1	17.6	28.1	–10.5	27.0
Nongovernmental loans[c]	519.2	76.3	442.9	162.0	280.9	867.9	104.9	763.0	236.8	526.2	320.1
Long-term issues to insurance companies[d]	55.0	4.1	50.9	14.8	36.1	71.1	6.1	65.0	11.7	53.3	14.1
Government loans	24.3	0.8	23.5	5.8	17.7	29.2	0.7	28.5	0.2	28.3	5.0
Nongovernmental loans[e]	30.7	3.3[f]	27.4	9.0[f]	18.4	41.9	5.4	36.5	11.5	25.0	9.1
Option-type[g]	206.1	128.8	77.3	83.3	–6.0	396.9	102.4	294.5	63.0	231.5	217.2
Development loan[g]	14.5	43.6	–29.1	31.1	–60.2	223.1[h]	41.0	182.1	21.4	160.7	211.2
Nongovernmental loans[g]	191.6	85.2	106.4	52.2	54.2	173.8	61.4	112.4	41.6	70.8	6.0
Bonds traded in foreign currency[i]	152.3	32.0	120.3	56.5	63.8	197.0	38.9	158.1	71.5	86.6	37.8
Total regular bonds	**935.9**	**253.9**	**682.0**	**355.0**	**327.0**	**1,563.6**	**265.4**	**1,298.2**	**411.1**	**887.1**	**616.2**

Absorption and Defense Loans[j]											
Absorption Loan	15.2	59.0	−43.8	23.4	−67.2	7.3	63.8	−56.5	40.8	−97.3	−12.7
Defense Loan	321.8		321.8		321.8	448.3		448.3		448.3	126.5
Compulsory Savings Loan	276.1		276.1		276.1	585.8		585.8		585.8	309.7
Total compulsory loans	613.1	59.0	554.1	23.4	530.7	1,041.4	63.8	977.6	40.8	936.8	423.5
Bank Defense Loan	86.7		86.7		86.7	101.3		101.3		101.3	14.5
Shares	0.0		0.0			52.8		52.8			

[a] Excluding sales of foreign securities in Israel. The data in this table relate only to issues with a prospectus and Government issues.
[b] This table includes a breakdown of redemptions according to principal, interest, and linkage differentials. The 1970 *Annual Report* gave a breakdown of redemptions of principal only.
[c] Consists mainly of financial institution issues.
[d] The reference is to the deposits made by the insurance companies with the Bank of Israel and not to the value of Insurance Companies Loan certificates into which the deposits are converted at fixed dates during the year.
[e] By the Israel Electric Corporation.
[f] These estimates assume that none of the bonds issued by the Electric Corporation and registered on the Exchange were held by insurance companies.
[g] Includes early redemption (actual figures for Government loans and estimates for nongovernmental loans).
[h] Includes the Development Loan issue sold to the banks, in the amount of IL 3.6 million in 1970 and IL 0.4 million in 1971.
[i] The data were calculated in Israeli pounds, according to the official rate of exchange: until August 1971 at IL 3.5 to the dollar, and from August 1971 at IL 4.2 to the dollar.
[j] The amount collected from the public and not the value of the certificates distributed.

SOURCE: State Loans Administration, Bank of Israel.

Table XVIII–2

MEDIUM- AND LONG-TERM BOND ISSUES,[a] 1971

(IL million)

End of period	Medium-term option-type bonds: Government[b]: Development Loan sold to public	Bank Development Loan	Defense Loan sold to public[c]	Bank Defense Loan	Others	Total	Long-term bonds: In Israeli currency: Development Loan sold to public	Others	Total	In foreign currency[d]
1970	10.9	3.6	75.1	86.7	191.6	367.9	3.3	519.2	522.5	152.3
1971	222.7	0.3	0.2	101.3	173.6	498.2	30.7	867.9	898.6	197.0
January	1.2	–	–	6.3	15.3	22.8	–	39.6	39.6	16.1
February	1.3	0.1	–	6.0	10.0	17.4	–	38.6	38.6	14.3
March	1.7	0.1	0.1	1.2	16.6	19.7	–	84.5	84.5	8.1
April	3.5	–	–	–	8.5	12.0	–	55.2	55.2	19.4
May	4.5	–	0.1	11.1	14.3	30.0	–	34.6	34.6	22.0
June	4.2	–	–	11.4	10.0	25.6	–	44.9	44.9	27.7
July	4.8	0.2	–	10.8	13.2	29.0	–	39.4	39.4	2.5
August	27.9	–	–	10.5	9.1	47.5	11.5	111.5	123.0	21.0
September	43.1	–	–	10.9	15.2	69.2	10.4	91.4	101.8	8.5
October	46.6	–	–	11.6	13.9	72.1	7.0	131.5	138.5	26.7
November	50.5	–	–	11.0	28.9	90.4	1.5	91.2	92.7	18.1
December	33.4	–	–	10.5	18.6	62.5	0.3	105.5	105.8	12.6

[a] Actual sales, including Government loans and all securities sold with a prospectus. However, not all were listed on the Stock Exchange, especially long-term bonds. Does not include the long-term Insurance Companies Loan.

[b] Excluding the Absorption Loan, the Insurance Companies Loan, and Defense Loan series from 1970 onward.

[c] Mainly the 1969 Defense Loan.

[d] Including Hollis.

SOURCE: State Loans Administration.

index-linked bonds as a hedge against the inflation and its expected persistence after devaluation. These bonds were purchased both directly and indirectly – the latter through approved saving schemes and mutual funds. Some of the substantial increment accruing in 1971 on assets linked to the exchange rate (Pazak and Tamam accounts and bonds traded in foreign currency) because of the revaluation of the German mark and the devaluation of the Israeli pound was used for acquiring index-linked bonds as part of the process of portfolio adjustment, and this too boosted sales of option-type loans.

Most of the option-type issues were floated between August and December, when the yield to maturity on Absorption and Defense Loans traded in the secondary market slipped noticeably. Although both quotations and the volume of trade in the secondary market rose sharply during those months, most of the incremental demand for option-type loans was satisfied by purchases at source, because of the downturn in the yield to maturity and the inability of the secondary market to cope with such a strong demand.

The distinguishing feature of the new issue market in Israel is the degree of supervision and control exercised by the Government. This stems from the fact that the Government deems it necessary to actively intervene in the saving-investment process. Every issue requires the Government's authorization, and it also decides whether the issue will qualify for income tax concessions; such authorization is conditional on the uses to which the proceeds are to be put. The Government fixes the rate of interest and itself issues bonds both directly and indirectly (by granting permits to financial institutions to issue bonds whose proceeds are to be deposited with the Treasury). Government intervention in the primary market also takes the form of guaranteeing institutional demand for new issues: it can require social insurance funds, bank-administered saving plans, and insurance companies to invest a certain percentage of their assets in bonds.[12] But the principal form of Government intervention in the saving-investment process is the guaranteeing of a supply of relatively low-risk bonds and covering the differential between the high rate of interest paid to investors and the low rates charged to the final users of the funds. The Government controls the allocation of the bond proceeds by directly floating certain issues by itself and by requiring that part of the financial institutions' issues be deposited with the Accountant General (making it analogous to a direct Treasury issue), and part be used for the granting of Treasury-approved loans, leaving only a relatively small balance for the discretionary use of the issuing institutions. As a matter of fact, this too goes in the main to finance the participation of the issuing institutions in projects approved by the Government and largely financed by it. It will thus be seen that all of the proceeds are subject to Government control, and the market plays no direct role in determining the price of capital or its allocation. The only portion of the bond issue proceeds freely allocated by the issuing institutions is that arising from the difference between the life of the bonds and the period of the loan for the projects that the Government obliges them to finance with the issue proceeds. During this interval the issuing institutions may use the funds as they wish, but here too their freedom is being whittled down.

In 1971 the composition of gross option-type loan issues changed. The share of Government loans jumped from 7 percent of the total in 1970 to 56 percent (see Table XVIII-1). The reduced share of the financial institutions stemmed partly from the attempt to limit their role as intermediaries in bond issues in favor of direct issues by the Treasury. From the investors' viewpoint, this step was of no significance, and hence there was no change in their preferences, though apparently the advertising campaign for

12. It should not be inferred that were it not for this requirement these institutions would not voluntarily invest a large portion of their assets in such paper. But this cannot be taken for granted, and certainly there would not be such a close link between accumulation and investment.

the option-type Government Development Loan issues and the lack of such publicity for other issues had some effect.

Net issues of long-term bonds reached IL 781 million, as against only IL 434 million in 1970. The bulk of the sum was mobilized in the last five months of the year (see Table XVIII-2). There were two principal reasons for this. One was that in the first half of the year, particularly in the second quarter, purchases were put off because of rumors of an imminent rise in the interest rate on this type of paper. At the beginning of August the rate was raised from 5.5 percent to 6 and 6.5 percent on index-linked issues, and the deferred purchases were now made.[13] The second reason was connected with the expectation of a general price rise after the August devaluation. Investors apparently advanced their purchases in anticipation of a rise in the consumer price index (the financing of such purchases was made possible by the relatively high liquidity of the banks).[14]

Net issues of bonds denominated in foreign currency by Israeli companies and institutions, including Hollis, were up from IL 120 million in 1970 to IL 158 million. A detailed analysis of developments in this type of paper is given in section 8.

(b) *The secondary market*

The secondary bond market accounted for 59 percent of total Stock Exchange volume in 1971, compared with 57 percent in the preceding year. Bond transactions were, at IL 368 million, up 66 percent, as contrasted with rises of 4.5 and 15.6 percent in 1970 and 1969 respectively (see Table XVIII-3).[15] However, it was the share market that proved more glamorous in the year reviewed, as reflected by the increase in volume and quotations. The livelier activity in the bond market in 1971 can be ascribed primarily to the more buoyant demand by the general public for financial investments linked to the consumer price index and to portfolio adjustments after the August devaluation. This brought up the yield to maturity on bonds pegged to the exchange rate and depressed that on index-linked and option-type bonds in the postdevaluation period. Most of the rise in volume was concentrated in option-type loans (74 percent of the total increase) and in bonds traded in foreign currency (23 percent), while other types of bonds listed on the Exchange experienced either a fall or a very mild growth of turnover.[16] The marked increase in the case of option-type loans was concentrated, as noted, in the last five months of the year, when the volume reached a monthly average of IL 22 million, as

13. Bonds paying 6 percent interest are issued for 17 years, and those paying 6.5 percent for 20 years (in both cases redemption begins in the tenth year).
14. This response was particularly strong in 1971 as compared with previous postdevaluation periods, because of the imposition of price controls immediately after the devaluation and the dealers' commitment to sell their stocks of imported goods at the old prices. This virtually ensured a rise of prices toward the end of 1971 and the beginning of 1972, when old stocks would be exhausted and price controls lifted.
15. At the time of writing this chapter no data were available on the volume of bond transactions in the over-the-counter market, the matching of buy and sell orders by brokers, and transactions among large institutional investors; we therefore had to limit the discussion to data on Stock Exchange transactions.
16. Most long-term bonds are not listed on the Stock Exchange, and since data on the volume of transactions in these bonds are not available, the analysis does not apply to them.

GENERAL TRENDS IN STOCK EXCHANGE TRADING, 1969-71

(IL million)

	Bonds								
	Linked to the exchange rate	Linked to the c-o-l index	Option-type	Traded in foreign currency	Non-linked and mixed linkage	Total	Short-Term Loan	Shares[a]	Total securities
1969	69.0		103.0	39.2	1.0[b]	212.2	137.2	107.1	456.5
1970	19.6	49.8	102.3	48.9	1.1	221.7	115.7	52.3	389.7
1971	15.4	56.8	210.4	82.2	3.3	368.1	150.1	105.7	623.9
1971 January	1.6	4.1	13.7	4.3	0.1	23.8	10.3	6.9	41.0
February	1.3	4.4	13.0	3.6	0.2	22.5	8.4	8.1	39.0
March	1.4	4.0	13.9	5.8	0.3	25.4	12.4	5.6	43.4
April	0.9	4.9	14.6	5.3	0.5	26.2	9.2	3.3	38.7
May	1.0	5.1	14.9	5.3	0.3	26.6	11.3	3.8	41.7
June	1.0	5.3	15.9	4.7	0.1	27.0	11.0	4.0	42.0
July	1.0	4.6	15.5	5.4	0.1	26.6	12.0	5.5	44.1
August	2.1	5.7	19.4	7.8	0.1	35.1	20.2	15.4	70.7
September	1.4	3.2	20.6	8.6	0.1	33.9	14.0	10.5	58.4
October	1.2	4.8	18.5	9.4	0.1	34.0	10.6	17.7	62.3
November	1.2	5.7	23.8	11.2	0.1	42.0	15.9	12.4	70.3
December	1.3	5.0	26.6	10.8	1.3	45.0	14.8	12.5	72.3
			Percent annual increase or decrease (–) in 1971						
1970	0.6		–0.7	24.7	–[c]	4.5	–15.7	–51.2	–14.6
1971	–21.4	14.1	105.6	68.1	–[c]	66.0	29.7	102.1	60.1
			Percentage distribution						
1969	15.2		22.6	8.7	–	46.5	30.1	23.4	100.0
1970	5.0	12.8	26.3	12.5	0.3	56.9	29.7	13.4	100.0
1971	2.5	9.1	33.7	13.2	0.5	59.0	24.1	16.9	100.0

[a] Listed ordinary and preferred shares, unlisted shares traded off the floor, and shares traded in foreign currency.
[b] Estimate.
[c] Because of the small sums involved the percentage change lacks significance.
SOURCE: Tel Aviv Stock Exchange.

against IL 14.5 million for the first seven months. In August and September the yield to maturity on these securities dipped, but in the last quarter the yield on a linked basis again turned upward, as the prices of these loans increased by less than the linkage differentials[17] (see Table XVIII-4).

In 1971, too, the Defense Loan topped the list of option-type bonds, accounting for about three-quarters of total turnover. In the case of the 1967 issue (due for redemption in 1972), bond washing (the sale of bonds close to maturity, in the main to investors exempt from the payment of income tax thereon) took place on a large scale, with the result that this issue accounted for 30 percent of the total volume. This development underscores the fact that trade in the bond market is dominated by the various compulsory loans. Since they are not acquired voluntarily, some of the holders tend to sell the paper as soon as they are pressed for cash; for this reason a lively trade takes place in these loans as long as market conditions favor it.

Turnover in listed bonds traded in foreign currency held steady during the first seven months of the year (the monthly figure averaged IL 5 million, compared to IL 4.6 million in the last quarter of 1970); this indicates the absence of expectations of an imminent devaluation. By contrast, after the devaluation of the Israeli pound and the consequent portfolio adjustments, turnover rose strongly, reaching a monthly average of about IL 9.5 million during the last five months of the year. Nevertheless, trading in such bonds is relatively small, apparently because some of them are held by foreign investors, who conduct most of their transactions outside the Tel Aviv Stock Exchange. They are guided by considerations different from those of Israeli investors.

The downtrend in transactions in bonds linked to the rate of exchange carried over through the year reviewed. This trend is explained by the fact that such securities have not been issued for quite a few years, and the outstanding balance is dwindling steadily as a result of redemptions. The curve traced by yields to maturity over the year indicates that the devaluation of August came as a surprise. During the first eight months the yield curve ascended weakly, suggesting that investors did not believe devaluation was in the immediate offing, while following devaluation the curve rose precipitately, owing to the increased redemption value and the realization of capital gains.

Trading in bonds linked to the cost-of-living index moved up from IL 50 million in 1970 to IL 57 million, or by 14 percent. This relatively mild advance, despite the much heavier demand for securities offering a hedge against the depreciation of the currency, is explained by the dominant position of the compulsory Absorption Loans in total Stock Exchange transactions in index-linked bonds (92 percent of the aggregate figure). In 1971 redemptions of the Absorption Loans – including principal, interest, and linkage differentials – rose from IL 82 million to IL 104 million, while the value of certificates distributed plunged from IL 150 million to IL 64 million. This reduced the stock of certifi-

17. In contrast to shares, bond price movements are a poor indicator of the development of demand for this type of financial asset, and it is the yield to maturity that has to be analyzed. Furthermore, because of the limited trade in option-type bonds other than the Defense Loan, which precludes the satisfaction of demand, investors sometimes have to buy at source even when the rate of return is higher in the secondary market.

AVERAGE NET YIELDS TO MATURITY[a] OF BONDS TRADED ON THE EXCHANGE,[b] 1971

(percentages)

Month[c]	Dollar-linked				Index-linked[d]				Option-type[e]: On a linked basis			Option-type[e]: On a nonlinked basis		
Years to maturity	Up to 2	2–5	5+	Total	Up to 2	2–5	5+	Total	Up to 2	2–5	Total	Up to 2	2–5	Total
1970 December	0.8	1.9	3.3	3.0	5.8	6.1	4.9	5.7	4.4	6.0	4.8	12.6	11.9	12.4
1971 January	−2.3	1.5	3.7	2.7	6.2	5.2	4.6	4.8	4.6	6.0	5.0	12.3	11.3	12.0
February	−0.1	1.4	3.6	2.7	6.8	5.9	4.9	5.4	6.3	6.5	6.3	13.3	11.2	12.7
March	1.2	1.5	3.7	3.0	5.3	5.3	4.7	4.9	5.6	6.5	5.8	13.0	11.3	12.6
April	0.9	1.8	3.7	3.0	6.7	4.8	4.7	4.9	5.3	6.3	5.5	12.0	10.7	11.7
May	2.7	2.3	4.0	3.6	6.1	5.3	4.7	4.9	6.1	6.7	6.2	12.6	10.9	12.2
June	3.4	3.1	4.5	4.1	6.0	5.6	4.6	4.9	6.2	6.9	6.3	12.6	11.0	12.3
July	2.6	2.5	4.3	3.9	6.7	5.2	4.6	4.8	6.1	7.0	6.3	12.9	11.1	12.5
August	−2.6	0.5	3.3	2.2	2.8	4.4	4.5	4.3	3.6	6.0	4.2	11.1	10.4	11.0
September	9.7	3.9	6.5	6.7	3.7	4.2	4.7	4.5	4.5	5.3	4.7	12.4	9.7	11.8
October	10.0	4.6	6.7	6.9	7.4	5.2	5.2	5.2	6.6	6.1	6.5	11.2	9.2	10.8
November	10.5	8.3	6.9	7.5	–[f]	5.2	5.2	5.2	6.7	5.5	6.5	8.5	7.8	8.4
December	9.6	7.7	6.4	6.9	–[f]	5.2	4.9	5.0	8.5	6.4	8.0	8.1	8.1	8.1
Yields on newly issued bonds[g]		No sale					4.5-4.9				4.84			10.76

a Less 25 percent income tax in the case of dollar- and index-linked bonds, while for option-type bonds the yield to maturity is gross because of bond washing (calculated according to the price of the security one day before maturity). The brokerage commission has been taken into account for all series, so that the figures cited are the net yields to the purchaser.

b The principal type of bond excluded here (as only a small fraction is listed on the Exchange) is the long-term paper sold to social insurance funds and insurance companies. The Absorption Loan and the 10-year Defense Loan are also excluded from the data, even though they are traded on the Exchange and account for the lion's share of the volume. This diminishes the significance to be attached to the rates of return listed here.

c According to the quotations on the 18th of each month.

d Excluding the Absorption Loan.

e Excluding the 10-year Defense Loan. The yield to maturity on option-type loans is gross, because of the practice of bond washing.

f Data no longer published.

g For comparison with the yield to maturity in the secondary market, several tenths of a percentage point have to be deducted, because the price of the security one day before maturity is fractionally less than the gross redemption value. The yields on newly issued index-linked bonds relate to 17- and 20-year series.

SOURCE: Central Bureau of Statistics.

cates in the hands of the public, and accounted for the relatively small increase in trading volume. A further reason was the abrogation in April of the possibility of opening new accounts in the "conversion-type" saving schemes, which in the past were one of the leading purchasers of the Absorption Loan.[18]

No significant changes took place in the institutional structure of the secondary market during the year. The Government continued to refrain from direct intervention in this market, except for limited intervention by the Bank of Israel in order to maintain the liquidity of those series of Government bonds which have a small turnover. Bond transactions were less heavily concentrated in a relatively few issues this year (see Table XVIII-7). This is attributable to the general growth of turnover, and in particular that in bonds denominated in foreign currency or linked to the exchange rate, which in previous years were marked by a comparatively light trade.

Table XVIII–5

MONTHLY INDEX OF SECURITY PRICES ON THE TEL AVIV STOCK EXCHANGE, 1971

(December 30, 1970 = 100)

End of month	Linked bonds						Non-linked[a]	Shares	
	Total	Dollar-linked	Index-linked			Mixed linkage		Pre-ferred	Ordi-nary
			Total	Long-term	Option-type				
January	100.1	100.0	100.1	99.7	100.5	100.3	103.9	102.5	103.3
February	100.4	100.5	100.4	100.1	100.3	100.4	101.2	104.1	106.6
March	101.3	98.5	101.4	101.9	100.8	100.8	103.4	102.8	106.6
April	102.4	97.1	102.6	102.8	102.4	101.2	113.1	103.7	103.5
May	101.6	94.9	101.8	102.7	101.3	101.3	110.8	108.5	104.7
June	102.2	94.6	102.4	103.6	101.6	100.9	106.1	112.8	105.1
July	103.6	96.5	103.9	104.6	103.2	101.3	107.8	120.2	107.9
August	105.6	105.0	105.7	105.6	105.5	108.5	107.7	120.4	118.1
September	106.0	103.0	106.1	106.4	105.8	108.9	110.8	124.2	122.6
October	107.9	102.2	108.2	109.0	107.5	110.5	111.7	125.4	124.2
November	108.8	102.3	109.1	110.7	108.0	111.7	111.7	127.0	119.6
December	110.0	103.4	110.3	112.9	108.7	114.8	109.3	132.7	123.0

[a] Excluding the Short-Term Loan.
SOURCE: Central Bureau of Statistics

18. For a detailed description of the "conversion-type" savings scheme see "Approved Saving Schemes, 1955-1969", Bank of Israel, *Economic Review*, No. 35, November 1970.

4. The Share Market

After several years of stagnation, the share market began to revive in 1971, with respect both to new issues and to turnover and price developments in the secondary market. Trading volume doubled and the monthly index of ordinary share prices[19] advanced 23 percent during the year (after retreating 11 percent in 1970 and 1.4 percent in 1969). New issues came to IL 52.8 million, as contrasted with no new issues at all in 1970 and IL 28.5 million in 1969.

(a) *The secondary market*

In analyzing developments in the share market and in order to understand the turnaround that took place in 1971, the year should be divided into two subperiods: the first seven months preceding the August devaluation and the following five months. In the first subperiod trade (both within and outside the Stock Exchange) averaged about IL 14.5 million a month, while in the second period the average rose to IL 23.4 million. The movement of share prices revealed a similar pattern: in the first seven months they firmed somewhat and the monthly index climbed 7.9 percent, while in the remaining five months the upward trend picked up considerable momentum and the index jumped a further 15.1 percent. A number of factors apparently combined to bring on the first-period recovery: (a) the strong monetary expansion, which resulted in liquidity surpluses in the banks and thus enabled them to finance speculative purchases; (b) the fact that shares were grossly undervalued, which made them a potentially good buy (as measured by the price-earnings ratio); (c) the appearance of a new mutual fund investing in equities, which started off with a sizable portfolio and was ready to guarantee purchasers of participation certificates against capital losses and to ensure them a minimum profit; (d) the drop in bond yields on the secondary market (particularly with respect to compulsory loans) to the level generally obtaining for issues acquired at source, thus wiping out the chances of capital gains; and (e) a favorable turn in the general mood regarding equity investment. The recovery was reflected by an increase in volume (both on the Exchange and in over-the-counter transactions), which rose from a monthly average of IL 8.3 million in the second half of 1970 to IL 14.5 million in the first seven months of 1971,[20] and by the 7.9 percent advance in the monthly price index, after it had held steady during the second half of 1970. Devaluation expectations played no part in the recovery at the beginning of the year, as they were then not very strong in either the capital or money markets (see section 7 below).

19. This index shows the change in the price of shares, weighted according to the capital registered on the Stock Exchange and excluding accumulated dividends and other benefits. The daily share index, on the other hand, assigns the same weight to all shares, without deducting accumulated dividends or any other benefits distributed to the shareholders. Thus the daily index is essentially different from the monthly index.

20. Analysis of the volume of share transactions is important for three reasons: first, it is an indicator of investors' interest in shares; second, it shows the volume of demand and supply which can be absorbed by the market without major disruptions; and finally, it indicates expectational changes regarding the development of share prices.

Table XVIII–6

MONTHLY SHARE TURNOVER ON TEL AVIV STOCK EXCHANGE AND OVER-THE-COUNTER MARKET, BY SHARE GROUP,[a] 1971

(IL thousand)

Month	Finance and insurance[b]	Land and development	Industry and commerce[c]	Fuel and oil	Investment companies	Listed pre-ferred shares & unlisted shares sold off the floor	Total[d]
January	3,429	907	1,240	119	871	340	6,906
	7,317	408	352	69	2,479	184	10,809
February	3,705	1,006	1,749	235	830	561	8,086
	5,356	902	1,399	361	1,246	317	9,581
March	2,385	625	1,492	119	787	209	5,617
	8,223	331	725	61	695	73	10,108
April	1,632	405	635	73	396	147	3,288
	4,476	140	277	18	1,620	66	6,597
May	1,949	536	749	126	367	117	3,844
	4,693	406	293	37	1,754	112	7,295
June	2,161	353	890	145	323	125	3,997
	4,925	108	417	28	489	64	6,031
July	2,323	750	1,513	268	424	224	5,502
	12,255	282	536	112	1,038	83	14,306
August	6,249	3,052	2,565	468	1,713	1,346	15,393
	5,672	1,110	907	160	1,846	593	10,288
September	3,799	2,139	2,200	278	1,495	549	10,460
	5,540	521	963	93	3,682	124	10,923
October	8,623	2,603	3,244	639	1,648	956	17,713
	5,556	860	1,114	276	1,140	160	9,106
November	4,883	1,984	2,748	322	1,252	1,228	12,417
	4,092	763	800	119	977	397	7,148
December	4,883	1,106	3,538	254	1,239	1,448	12,468
	7,459	1,099	1,164	88	1,025	470	11,305
Total	46,021	15,466	22,563	3,046	11,345	7,250	105,691
	75,564	6,930	8,947	1,422	17,991	2,643	113,497

[a] Upper and lower figures indicate the volume of trade on and outside the Stock Exchange (the over-the-counter market) respectively.
[b] Shares traded in both Israeli and foreign currency.
[c] Includes public utilities.
[d] Discrepancies in total are due to the rounding of individual figures.
SOURCE: Tel Aviv Stock Exchange.

It was against this background that the external value of the Israeli pound was changed in August. The bullish upswing picked up steam: trading volume rose to a monthly average of IL 23.4 million and the monthly index of ordinary share prices jumped by a further 15.1 percent. All groups shared in the recovery, with oil, industrial and commercial, and land and development stocks setting the pace, while investment companies and the finance and insurance group rallied later and less strongly (this pattern

Table XVIII–7

DISTRIBUTION OF ORDINARY SHARES AND BONDS BY ANNUAL TRADING VOLUME,[a] 1971

Annual volume (IL '000)	Ordinary shares[b]		Bonds[c]	
	Number of shares	Percent of total volume	Number of bonds	Percent of total volume
Up to 99	7	0.0	53[d]	0.2
100-249	11	1.1	11	0.5
250-499	14	2.7	9	1.0
500-999	9	3.3	6	1.2
1,000-2,499	21	16.0	10	4.4
2,500-4,999	12	21.2	5	4.5
5,000-9,999	10	37.2	7	13.8
10,000+	1	18.5	6	74.4
Total	85	100.0	107	100.0

a The data for shares relate to trade in listed shares sold on the Stock Exchange (both on and off the floor) and in the over-the-counter market, while the data on bonds relate only to trade on the Exchange. The distribution is by issuer only, and not by individual issues; that is, all types of shares issued by a particular company and all series of the same type of bond floated by a particular issuer are treated here as a single unit.

b For a group breakdown see Appendix Table A-XVIII-2 (in Hebrew only).

c Excluding the Short-Term Loan. For a group breakdown see Appendix Table A-XVIII-3 (in Hebrew only).

d There was no trading in 19 of the 53 issues.

SOURCE: Tel Aviv Stock Exchange.

is reflected in both volume and quotations). Apparently the main thrust in the post-devaluation period came from speculative expectations[21] of a steep price rise and a repetition of the boom conditions that marked the period immediately after the 1962 devaluation. Other contributory factors were the realization of devaluation increments and their reinvestment in shares, the excess liquidity of the banking institutions, and the host of small investors who entered the market (a general phenomenon after the onset of an upward trend). The outcome of all these factors was a vigorous bull market, which reached new heights at the beginning of 1972.

A glance at Table XVIII-5 shows that in November the index of ordinary share prices retreated somewhat, from 124.2 at the end of October to 119.6. This can be attributed to profit-taking (a typical development on any exchange when prices are

21. A distinction must be made between the motives of investors and those of speculators. The former base their decisions on the long- and medium-term prospects of firms and shares, while the latter are concerned with very short-term changes in share prices.

rising), which was given an added push by the announcement of the freezing of bank credit and rumors (later denied) of an impending freeze on dividend payments in 1972.

Transactions in the over-the-counter market are of two types. The first is the matching by brokers of buy and sell orders of the general investing public, with only the balance being brought to the Exchange at the opening of the day's trading. The second type consists of transactions of institutional buyers (investment companies, mutual funds, etc.) who for various reasons (including the desire to avoid brokerage commissions and anxiety about the effect which large demands or offers on the Exchange may have on prices) prefer to execute most of their transactions outside the Exchange. By contrast, the bulk of the trade on the Exchange represents orders of the general public which were not matched by brokers.

Table XVIII-6 shows that during the first half of the year the proportion of over-the-counter share transactions increased somewhat relative to those executed on the Exchange. In the second quarter the ratio stood at 1.79 for all shares. In the finance and insurance and the investment companies groups the ratios were particularly high – 2.45 and 3.55 respectively. In the third quarter a decline set in and it grew sharper in the final quarter, when the ratios fell to 0.65 for all shares and to 1.93 and 0.76 in the finance and insurance and the investment companies groups respectively. This suggests that most of the increased volume can be attributed to the general public (investors and speculators) and not to institutional investors.

The beginning of the year saw the establishment of a new mutual fund specializing in shares, which guaranteed purchasers of its certificates against capital losses and ensured a minimum profit for a five-year period. In the first half of the year the fund raised a total of IL 8.7 million, but in the second half there was a net redemption of certificates in the amount of IL 1.3 million. The latter development, at a time when the share market was booming, suggests that the relative importance of investor-savers in the market declined during these months and that of speculators grew, with all that this implies for explaining developments during the year and the prospects of sustaining the boom.

(b) *New share issues (primary market)*

Considering the developments that took place in the secondary market in 1971, a resumption of new equity issues on an appreciable scale might have been expected. In view of the strong rise of prices and trading volume it would seem that the market could easily absorb new issues at relatively high prices. As a matter of fact, there were new issues to the tune of IL 52.8 million (as against no issues at all in 1970); but this amount was less than expected, and an examination of its composition indicates that only a small part can be regarded as indicative of a change in the market trend.

The issues consisted of three series of share rights by financial institutions,[22] totalling IL 12.8 million; a IL 10.5 million issue by a banking concern to the general public; a IL 25 million issue by the same firm of capital notes convertible into shares; and for the first time in several years, an issue by an industrial company (which previously had not

22. Tefahot Israel Mortgage Bank, General Mortgage Bank, and the Israel Development and Mortgage Bank.

gone public) to the value of IL 2.5 million, along with a IL 2 million issue of convertible bonds.

A differentiation must be made between the various share groups when analyzing their contribution to market trends. Financial institutions must be distinguished from all other groups, particularly industrial firms. In Israel financial institutions customarily float numerous bond issues, and as a result every few years they have to increase their equity capital in order to preserve an appropriate ratio between the two types of financing. In general such issues are influenced to only a minor extent by the business outlook or by changes in the firms' methods of financing. It is in this light that the three aforementioned financial institution issues must be viewed. As mentioned, these were rights issues and hence were not offered to the general public but to holders of the institutions' shares (an additional characteristic of issues of this type). The bank issues may be regarded in a similar fashion. This concern, too, has to maintain a certain ratio between its equity capital and its total assets, but it is highly revealing that it deemed the market capable of absorbing a new issue of shares and of capital notes and made the offering to the general public, not merely to its own shareholders.

The situation is different concerning the industrial firm. In going to the market it departed to some extent from the tendency of the past several years, during which firms refrained from turning to the capital market for mobilizing funds. The reasons for this are to be found in both the supply and demand conditions. Cheap Government development loans constituted a more attractive alternative, while the listlessness of the share market discouraged potential investors. However, even when a company can raise soft long-term credits it must have some equity capital.[23] Thus, in the years when the Stock Exchange slump made the prospects of floating new issues very slim, industrial companies apparently made private placements in spite of all the disadvantages thereof. Even in the year reviewed, when the Stock Exchange could have absorbed new equity issues, the situation did not change much. There were apparently two main reasons for this reluctance to raise capital through public offerings. First, the various funds providing cheap financing were still operating. Second, Israeli firms tend to rely more on self-financing – from family sources or from the parent company – in order to avoid going public, with the resulting obligation of revealing information and the possible intervention of new shareholders in the management of the firm. In addition, the small size of most local companies makes it difficult for them to float public share issues.

It should be noted that direct Government control and intervention is much more limited in the case of share issues than of bonds, though the former also requires Government authorization. But the Government indirectly influences the volume of share issues in that it creates conditions which do not push or even encourage firms to turn to the share market to mobilize capital.

In conclusion, with the reawakening of the secondary share market there was also some revival of new issues to the public, but of a very tentative nature. If this development is not sustained, if the primary market does not continue to forge ahead in line with the sharp upward swing in the secondary market, this will have a depressing effect on the

23. This applies even to 1971, when the real interest on these loans was negative.

secondary market and the share market will continue to be unable to fulfill its central function.

Table XVIII–8

SECURITIES LISTED ON THE TEL AVIV STOCK EXCHANGE,[a] AT PAR AND MARKET VALUES, 1970-71

(IL million)

End of period	1970		1971		Percent increase or decrease (–)	
	Par value	Market value	Par value	Market value[b]	Par value	Market value
Bonds						
Dollar-linked	111.2	173.8	85.1	19.6	–23.5	–47.3
Index-linked	1,239.6	1,565.8	1,244.2	1,728.1	0.4	10.4
Traded in foreign currency	775.1	792.0	1,118.6	1,110.9	44.3	40.3
Option-type	1,454.5	1,806.9	2,228.1	3,058.9	53.2	69.3
Mixed linkage	14.9	27.9	7.9	18.5	–47.0	–33.7
Nonlinked	46.2	37.2	72.0	49.5	55.8	33.0
Total	3,642.4	4,403.6	4,755.8	6,057.5	30.6	37.6
Shares						
Ordinary	828.7	876.3	886.5	1,197.0	7.0	36.6
Preferred	25.7	25.8	25.7	34.5	0.0	33.7
Traded in foreign currency	186.5	178.3	187.8	256.6	0.7	43.9
Total	1,040.9	1,080.4	1,100.0	1,488.1	5.7	37.8

[a] Does not include all the issues sold with a prospectus; among long-term index-linked bonds there is a large percentage that is issued with a prospectus but is not registered on the Exchange. A distinction should also be made between the amount of securities listed on the Exchange and the actual marketable stock of securities, because of the existence of large blocks (held by individuals and institutions) which are not for sale.

5. SHORT-TERM LOAN

The outstanding balance of the Government Short-Term Loan was up IL 157 million in 1971, after an increase of IL 93 million in the previous year and a drop of IL 28 million in 1969. This accelerated rise took place during a period of rapid monetary expansion and helped dampen the rate of growth, although the net amount of funds absorbed by way of this paper was only IL 89 million.[24]

24. From the gross increase of IL 157 million we have to deduct interest on series reaching maturity and dealers' commissions. In analyzing the Short-Term Loan what is important is the net absorption and not net sales, as the purpose of this instrument is to mop up money and not to raise capital, in which respect it differs from both bonds and shares.

Table XVIII–9

SHORT-TERM LOAN HELD BY THE PUBLIC, BY REDEMPTION DATE, 1969-71

(IL million)

Number of days to redemption	Dec. 31, 1969		Dec. 31, 1970		Mar. 31, 1971		June 30, 1971		Sept. 30, 1971		Dec. 31, 1971		Change during 1971 (IL m.)
	IL m.	%	IL m.	%	IL m.	%	IL m.	%	IL m.	%	IL m.	%	
Up to 91	164.6	35.3	272.3	48.7	266.2	47.5	288.9	46.6	361.6	51.4	389.5	54.3	117.2
98 – 182	126.1	27.0	146.9	26.3	146.3	26.1	172.5	27.8	179.9	25.5	171.3	23.9	24.4
189 – 364	118.7	25.4	122.1	21.7	124.6	22.3	133.2	21.5	138.4	19.6	135.1	18.9	13.0
371 – 546	57.4	12.3	18.9	3.3	22.7	4.1	25.5	4.1	24.4	3.5	20.9	2.9	2.0
Total	466.8	100.0	560.2	100.0	559.8	100.0	620.1	100.0	704.3	100.0	716.8	100.0	156.6

SOURCE: State Loans Administration.

During the year the tendency for this loan (which is not value linked) to become less a capital market and more a money market instrument became stronger. This was due to the accelerated climb of prices in the course of the year and the growing propensity to purchase linked assets, which led to a further increase in the weight of series falling due within three months at the expense of the longer series. From the end of 1969 to the end of 1971 the former moved up from 35 to 54 percent of total holdings, while the 18-month series dropped from about 12 to 3 percent (see Table XVIII-9). In a period of advancing prices and expectation of a continuation of this trend, there is little demand for nonlinked medium- and long-term assets (particularly in 1971, when linked investments for one year were available on the Stock Exchange), and what remains is short-term demand in the money market, where there is no linked alternative available (for developments in short-term demand in the money market see Chapter XIV).

The growth of the public's Short-Term Loan holdings did not proceed at an even pace over the year. During the first quarter there was no change, the second quarter saw a rise of IL 60 million, and in the third quarter – because of the strong monetary expansion, the upping of the net yield by 0.5 to 0.75 of a percentage point,[25] and the better terms offered dealers – the level shot up by IL 85 million. In the last quarter the gain was only IL 13 million, in spite of the more attractive terms offered to investors. The increase was concentrated entirely in the three-month series, while other series fell off. The raising of the yield boosted sales, but the flurry was short-lived and the fourth-quarter figure, as already noted, went up by only IL 13 million. The more sluggish expansion in the final quarter is explained by the braking of monetary expansion during those months; the accelerated rise in the three-month series was due to the devaluation at the end of August, which prompted longer-term investors to switch to index-linked assets, and to the fact that the rate of return on the short series was raised by 0.75 of a percentage point as opposed to 0.5 of a point for the long series.

6. Compulsory Loans[26]

Compulsory loans imposed on the public brought in IL 1,041 million in 1971, as contrasted with IL 613 million in 1970. Redemptions of loans levied in preceding years (actually only the Absorption Loan) totalled IL 105 million in 1971, compared with the previous year's IL 82 million. Thus net receipts came to IL 937 million, as against IL 531 million in 1970 (see Table XVIII-1).

As explained in section 2 above, the compulsory loans cannot be regarded as part of the primary securities market, but they do account for part of domestic capital mobilization and to some extent have supplanted purchases of ordinary securities.[27] The

25. On August 4, 1971.
26. For the purpose of this section the term "compulsory loans" includes Defense Loan issues for 1968 and 1969. For a description of the differences in issue terms of these two series see Bank of Israel, *Annual Report 1970*, p. 387.
27. For a more detailed discussion of the question of how to treat compulsory loans in the analysis of the securities market see *ibid.*, p. 394.

IL 1,041 million raised from the public in 1971 consisted of collections of current-year payments and of arrears and commitments on account of previous years for three types of loans – Savings, Defense, and Absorption. The Savings Loan (a 4-6 year loan) produced IL 586 million, the Defense Loan (maturing in 15 years) brought in IL 448 million, and IL 7 million in arrears was collected on the Absorption Loan. Three principal reasons can be advanced for the larger compulsory loan collections in 1971. In the first place, in 1970 the loans were collected only from April, whereas in 1971 they were collected during the entire year. Secondly, because of the time-lag in the tax assessment of companies and self-employed, in 1970 loan collections from them began even later than April. Finally, the rise in nominal incomes in 1970 automatically increased Defense Loan collections.

It should be noted that even when certificates of the Savings and Defense Loans for 1970 onward are distributed, they will not be negotiable nor will they be listed on the Stock Exchange. Thus they probably will have no direct impact on either the primary or secondary market. But by affecting both the disposable incomes of households and their wealth (as distinguished from negotiable financial assets), they will have an indirect effect.

In 1971 Absorption Loan certificates were distributed to the tune of IL 63.6 million, as against IL 194.9 million the year before. IL 53 million was on account of the 1966 series, whose distribution began in December 1970, while the remaining IL 10.6 million was on account of previous years. The much smaller figure for 1971 is attributable not only to the fact that distribution of 1966 Absorption Loan certificates began only in the last month of the year, but in particular to the drastic IL 90 million decline in the case of the Defense Loan. This development affected both the securities portfolio of the public and demand for original-issue bonds, especially of the option type (see section 2).

In addition to the compulsory loans levied on all persons paying income tax (employees, self-employed, and companies), IL 101 million was collected on account of the Defense Loan issue to banks. Banking institutions took up this loan under a special arrangement with the Treasury covering, in part, the investment of their saving scheme funds. Purchases of this loan were partly at the expense of option-type loans. Adding the receipts from the bank Defense Loan issue brings up the total amount of capital raised by the Government in the form of compulsory loans to IL 1,038 million, as contrasted with only IL 617 million in the previous year.

7. Effect of Devaluation Expectations on Investors' Behavior

Investors' behavior in the capital and money markets is influenced by expectations of a change in the exchange rate for the Israeli pound, since some of the financial assets sold in these markets are either pegged to or denominated in foreign currencies. The reference is principally to securities traded in foreign currency, dollar-linked securities, and Natad, Pazak, and Tamam deposits.[28] Apart from bonds linked to the exchange rate, owners of

28. To this list should be added the free market dollar, even though it does not form part of the official Israeli money market.

these assets can switch their holdings from one currency to another, provided that they are among the 16 currencies which the Bank of Israel authorizes foreign exchange dealers to handle.[29]

In addition to the expectation of a change in the dollar parity of the Israeli pound, investors' behavior in the year reviewed was influenced by events in the international money market and the changes in the external value of a number of currencies.

Three indicators are normally used for analyzing devaluation expectations in Israel: the agio[30] on Natad dollars, the agio on free market dollars, and the yield to maturity on index-linked bonds.[31] The development of these three indicators in 1971 is shown in Tables XVIII-4 and XVIII-11. It turns out that the devaluation of the Israeli pound on August 22 took the money and capital markets by surprise, as devaluation expectations had gradually subsided during the preceding months. This must be viewed against the setting of the effective devaluation, as far as commodity imports and exports are concerned, which took place in August 1970, and also the realignment of the external values of the major world currencies. The first half of 1971 saw continued pressure on the U.S. dollar, with the principal European currencies and the Japanese yen gaining in strength. This development reached its peak toward mid-year, when the German mark was floated and in its wake a number of key European currencies were either floated or revalued. These happenings actually constituted an effective devaluation of the Israeli pound, and explain the waning of devaluation expectations and the lagging demand for assets linked to foreign currencies, particularly the dollar.

It was against this backdrop that the Israeli pound was devalued on August 22 by 20 percent relative to the dollar. This followed the U.S. Government's announcement severing the link between the dollar and gold and imposing a 10 percent import surcharge. These steps portended a devaluation of the dollar, which in fact took place at the end of the year at the rate of 8.3 percent. This step did not change the position of the Israeli pound relative to the dollar or other currencies linked to the latter.[32] But in relation to currencies not linked to the dollar, it constituted an effective devaluation of the Israeli pound, and by the same rate.

To conclude this section, it should be noted that an effective devaluation in the form of a revamped schedule of customs tariffs and system of export subsidies has no direct impact on holdings of assets denominated in foreign currency. It must therefore be stressed that, apart from the temporary imposition of an import surcharge by the U.S. in August, all the changes in the relative values of foreign currencies that took place in 1971

29. These are the currencies of the U.S., Canada, U.K., Australia, South Africa, Switzerland, France, Denmark, Sweden, Norway, the Netherlands, West Germany, Finland, Austria, Belgium, and Italy.
30. Defined as the ratio between the rate of exchange at which the transaction in question was actually effected and the lower official rate of exchange of the IL.
31. In spite of the differences among the three markets and the fact that part of the supply and demand cannot shift from one market to another, there is a high correlation among these three indicators, so that they can be used interchangeably.
32. With one reservation, namely that as long as the special U.S. 10 percent tax on imports was in force, there was an effective devaluation of the dollar in relation to the Israeli pound with respect to commodity exports from Israel.

affected financial assets linked to or denominated in those currencies and thus exercised a direct influence on the capital and money markets, as will be seen below.

8. Securities Traded in Foreign Currency and the Natad Market

Israeli residents may directly purchase securities traded in foreign currency, either with Natad dollars or with Tamam funds. The securities acquired in this manner are either listed on a number of the world's leading stock exchanges or are issued by Israeli entities – various financial institutions and Hollis, a Jewish Agency subsidiary which issues participation certificates. At the end of 1971 the outstanding balance of foreign currency securities held by Israeli residents was about $325 million, compared with $252 million at the end of 1970 – an advance of $73 million or 29 percent. Of the increment, $34.5 million derived from the revaluation of assets and $38.6 million represented new purchases.[33]

Of the total balance outstanding at the end of 1971, issues of Israeli institutions (including Hollis) constituted about 80 percent and foreign securities only 20 percent. Thus it seems that the demand for foreign currency securities stems not so much from a desire to trade on foreign stock exchanges out of profit motives, but rather from the investor's desire to protect himself against a change in the external value of the Israeli pound. Reinforcing this view is the fact that the weight of bonds (a conservative investment) in the total amount placed in foreign securities is high, reaching 75 percent. The arrangement enabling Israelis to purchase foreign currency securities thus serves mainly to fill the gap created by the cessation of dollar-linked bond issues.[34]

In 1971 some IL 197 million of securities denominated in foreign currency were issued by Israeli institutions, while redemptions of earlier issues amounted to IL 39 million; the net sum mobilized thus came to IL 158 million[35] (see Table XVIII-1). About a quarter of the gross total was used by the Jewish Agency for redeeming earlier series and for financing its operations, a little over a quarter was deposited with the Treasury, and the remaining half went to financial institutions, which converted most of their receipts into Israeli pounds while hedging themselves against any possible change in the

33. The portfolio of securities traded in foreign currency is revalued once a year, in March; from then until the end of the year price changes are not mirrored in the data. However, the changes that took place during the year reviewed in the exchange rates of a number of foreign currencies were taken into account and included in total net purchases.
34. The banks' commission charges on the purchase and sale of foreign securities are higher than those charged on Israeli securities traded in foreign currency, and the minimum unit in which the former can be traded is relatively high, thereby constituting a constraint with respect to some of the assets of this sort. Regarding income tax on earnings from such securities, the arrangement varies from one country to another, but in general they are not at a disadvantage in comparison with earnings on Israeli securities traded in foreign currency.
35. In terms of foreign currency the amount issued in 1971 was over $50 million, but since most of the Israeli institutions issuing such securities convert the proceeds into Israeli pounds for financing their domestic operations, the Israeli pound figure has more relevance.

Table XVIII–10

NET PURCHASES[a] OF FOREIGN CURRENCY SECURITIES OUT OF TAMAM AND NATAD FUNDS, 1969-71

($ million)

End of period	1969	1970	1971			
			Total	Listed in Israel	Hollis	Listed abroad
Net purchases						
January	2.5	2.7	5.1	4.4	0.4	0.3
February	2.3	5.0	3.9	2.9	1.1	–0.1
March	2.8	0.7	0.8	0.9	–0.2	0.1
April	2.3	6.0	4.6	1.4	3.6	–0.4
May	2.8	5.2	3.4	3.7	0.1	–0.4
June	3.0	5.7	5.2	5.2	0.2	–0.2
July	2.4	3.9	5.1	4.6	0.1	0.4
August	2.3	2.4	1.9	1.3	–	0.6
September	1.0	2.5	2.5	2.2	0.1	0.2
October	2.6	3.1	2.1	1.3	0.2	0.6
November	4.5	2.7	0.9	–0.8	1.4	0.3
December	3.8	6.2	3.1	1.9	0.6	0.6
Total net purchases	32.3	46.1	38.6[b]	29.0	7.6	0.2
Revaluation[c]	18.7	–33.0	34.4			
Total increase in holdings	51.0	13.1	73.0			
Holdings at end of period	239.2	252.3	325.3	168.1	88.2	69.0

[a] Total securities purchased, less total securities sold during the period.
[b] Includes $1.6 million differentials due to changes in foreign exchange rates.
[c] The differential arising from the revaluation of the portfolio according to the prices at the end of March; does not include the increment arising from changes in foreign exchange rates.
SOURCE: Foreign Exchange Department, Ministry of Finance.

exchange rate before redemption date. The bulk of the foreign currency issues is sold to Israelis and only a small portion (about 20 percent in 1971) is sold to foreign nationals.

The pattern of demand for Natad dollars and securities traded in foreign currency was directly influenced by devaluation expectations during the year (see section 7). It is reasonable to assume that when a devaluation is anticipated in the near future, the demand for Natad (and free market) dollars will rise and that for foreign currency securities will fall. This is because of the relatively high commission charged for the purchase and sale of securities, a cost which is not worth incurring if an imminent devaluation is anticipated and the investor hopes to pocket the exchange rate differentials. On the other hand, when expectations of an imminent devaluation ebb but balance

Table XVIII–11

NATAD AND FREE MARKET DOLLAR RATES, NATAD BALANCES AND HOLDINGS OF SECURITIES TRADED IN FOREIGN CURRENCY, 1970–71

($ million)

	1970							1971						
	Securities traded in foreign currency[a]	Natad balances	Total	Natad dollar rate (monthly average)[b] (IL)	Agio on Natad dollar (%)	Free market dollar rate (monthly average)[b] (IL)	Agio on free market dollar (%)	Securities traded in foreign currency[a]	Natad balances	Total	Natad dollar rate (monthly average)[b] (IL)	Agio on Natad dollar (%)	Free market dollar rate (monthly average)[b] (IL)	Agio on free market dollar (%)
January	241.9	14.9	256.8	4.35	24.2	3.96	13.1	257.3	16.9	274.2	4.16	18.6	3.82	9.2
February	246.9	14.7	261.6	4.30	22.7	3.89	11.2	261.2	17.4	278.6	4.13	17.9	3.81	8.9
March	214.6[c]	16.7	231.3	4.34	23.9	3.91	11.8	296.5[c]	23.4	319.9	4.06	15.9	3.78	7.9
April	220.6	18.2	238.8	4.22	20.6	3.87	10.6	301.2	21.5	322.7	4.03	15.1	3.78	7.9
May	225.9	17.1	243.0	4.15	18.6	3.83	9.4	304.6	23.0	327.6	3.92	12.0	3.72	6.2
June	231.6	15.1	246.7	4.20	19.9	3.89	11.1	309.7	21.9	331.6	3.88	10.8	3.70	5.7
July	235.4	14.9	250.3	4.14	18.3	3.86	10.3	314.8	21.5	336.3	3.85	10.0	3.70	5.7
August	237.8	15.5	253.3	4.16	18.7	3.86	10.3	316.7	22.0	338.7	3.98[d]	13.8	3.77[d]	7.7
											4.31[e]	2.6	4.29[e]	2.0
September	240.3	15.3	255.6	4.15	18.7	3.88	10.9	319.2	24.3	243.5	4.24	1.0	4.27	1.8
October	243.4	16.2	259.6	4.13	17.9	3.87	10.6	321.3	21.6	342.9	4.23	0.7	4.28	1.9
November	246.1	17.6	263.7	4.05	15.9	3.82	9.1	322.2	20.2	342.4	4.25	1.1	4.47	6.4
December	252.3	17.9	270.2	4.17	19.0	3.82	9.1	325.3	22.3	347.6	4.28	1.9	4.52	7.6

[a] Changes in the monthly balances should be regarded as indicative of orders of magnitude only as, apart from March (the only month for which the portfolio was adjusted according to the prevailing market prices), the holdings were not revalued, while for sales and redemptions the full value is deducted and not the value as it appeared in March.

[b] Arithmetic average of the last trading day in the week.

[c] Includes $33.0 million revaluation increment in 1970 and $34.5 million in 1971.

[d] Before the devaluation.

[e] After the devaluation.

SOURCE: Bank of Israel and Foreign Exchange Department, Ministry of Finance.

of payments difficulties make such a step a virtual certainty in the more remote future, demand will mount for securities which, on top of foreign currency linkage, promise a current return. Since devaluation expectations subsided during the first seven months of the year, demand for securities traded in foreign currency outweighed that for Natad dollars, and the price of the latter drifted downward. During this period net purchases (excluding revaluation increments) of such securities came to \$28.1 million, out of the total of \$38.6 million for the entire year.[36] Stock Exchange transactions in bonds denominated in foreign currency also advanced during this period, from a monthly average of IL 4.2 million for the second half of 1970 to IL 4.9 million during the first seven months of 1971.

After the August devaluation households adjusted their portfolio of financial assets, in particular securities traded in foreign currency. Profit-taking set in and there was a switch to assets linked to the cost-of-living index. As a result, the agio on the Natad dollar sank very close to zero,[36] while Stock Exchange volume shot up from a monthly average of IL 4.9 million during the first seven months of the year to IL 9.6 million during the August-December period. (No figures are available on the yield to maturity for all bonds traded on the Exchange, but partial data indicate an upturn in the yield due to profit-taking.) Nevertheless, holdings of securities traded in foreign currency continued to expand and in the last five months of the year reached \$10.5 million.

Despite the pressure on the U.S. dollar during the year and the materialization of the expected revaluation of several European currencies, the weight of securities denominated in U.S. dollars in total foreign currency securities stood at a very high 93 percent. This can be ascribed to the fact that most of the Israeli securities traded in this market are denominated in dollars, and purchasers prefer the securities of Israeli entities known to them over securities denominated in other hard currencies, which involve dealing on unfamiliar foreign exchanges. It should nonetheless be noted that in the year reviewed the Treasury authorized a number of local issues denominated in Swiss francs.

There are two main sources of supply to the Natad dollar market: transfers from Tamam accounts by recipients of personal restitution from West Germany, and the repatriation of foreign currency security investments. The biggest demand for Natad dollars comes from purchasers of securities traded in foreign currency. However, from time to time the Natad dollar market is made to serve other functions, a common feature of which is their connection with international capital movements of the Israeli economy under circumstances where the competent authority has decided that their execution at the official rate of exchange rather than one closer to the equilibrium rate would be detrimental to the overall economic-policy aims.

The Natad dollar rate slipped steadily during the first eight months of the year (see Table XVIII-11), reflecting primarily the fading of devaluation expectations, and to a minor extent, the larger volume of personal restitution receipts from Germany. Even so, the Natad dollar rate stood a little above the free market rate throughout the entire

36. As can be seen from Table XVIII-11, Natad deposits also increased somewhat, from a monthly average of \$17.2 million in the last quarter of 1970 to \$20.7 million in the first half of 1971. This points to expectational changes regarding the date of devaluation.

period, continuing a trend evident since the previous devaluation in November 1967. By contrast, in the last four months of the year the agio on the Natad dollar dropped below that on the free market dollar, and part of the time it hovered at its minimum level. The supply of Natad dollars therefore outweighed demand at this price, so that for the first time in years not all of the funds shifted from Tamam accounts to the Natad dollar market could be absorbed, and these withdrawals became a direct source of external infusion into the economy.[37] At this stage it is difficult to judge whether the fact that the agio on the Natad dollar again dipped below that on the free market dollar was due solely to heavier conversions of personal restitution and Tamam funds, or whether there was a more fundamental change in the sources of demand for foreign currency (a shift from the free to the Natad dollar market).

37. In the past as well, when all withdrawals from Tamam accounts were absorbed in the Natad dollar market, that part of the new issue proceeds which was converted into Israeli currency resulted in an external infusion, but the infusion in the year reviewed had a direct inpact and was on a larger scale.