

CHAPTER XVIII

THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET¹

1. MAIN DEVELOPMENTS

In 1978 the public's accumulation of medium- and long-term financial assets was, at approximately IL 16 billion, up about 30 percent in real terms, after an unprecedented increase of 160 percent last year (see Table XVIII-6). This rise occurred over and above the rapid growth of short-term financial assets and investments in physical assets, and was largely made possible by the availability of a wide array of sources of finance, as well as of a real 5–7 percent gain in private saving. The decline in the accumulation rate was connected with the introduction of the Patam (Israeli residents' foreign currency deposits) arrangement.

The propensity to prefer institutional savings, such as approved savings schemes and social insurance funds, over direct holding of securities continued this year. This applies to index-linked investments, with the contrary being true of investments in shares and foreign currency assets, even though here too there are instruments for institutional saving. At the same time, there was real decline in net sales from securities portfolios held directly by the public; in light of a number of institutional and behavioral developments, the reshuffling of financial asset portfolios may come to a halt or weaken significantly.

Medium- and long-term credit extended this year to the various economic sectors, households, and others grew by 60 percent to reach IL 28 billion (see Table XVIII-2). But because of the price rises in the uses of this credit (an average of 68 percent), the purchasing power of such financing fell by 5 percent. Nondwelling investment rose 7 percent, mainly in industry, agriculture, and electricity, so that the decline in the rate of investment financing was even larger. Since it was not possible to separate the data on industrial investments implemented by the public sector, which do not require financing from the capital market, from total industrial investment, the estimated rate of financing is biased

¹ For a detailed description of the statistical-analytical framework see the Bank of Israel Annual Report for 1974, pp. 473 ff. The analytical framework has been expanded this year to include both financial intermediation between the foreign sector and local economic units through the commercial banks and direct government activities in the capital market. This rounds out the statistical and analytical framework of the institutional structure of the capital market in Israel as broadly defined.

TABLE XVIII-1

MAIN INDICATORS OF THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET, 1976-78
(IL million)

	1976	1977	1978	Percent annual real increase	
				1977	1978
A. Medium- and long-term credit					
1. Total credit for medium and long term	a	17,530	28,000	a	-5 ^b
B. Net accumulation of medium- and long-term financial assets by the public					
2. Total institutional household savings	6,580	12,000	17,780	36 ^c	-1
3. Direct bond purchases by the public and long-term linked deposits	-4,800	-6,770	-4,700	5 ^c	-31
4. Purchases of shares	600	3,000	2,800	271 ^c	-38
5. Total accumulation of the public in medium- and long-term channels	2,380	8,230	15,880	157	-29
C. Sources and uses of medium- and long-term funds of the govt.					
6. Surplus of sources over domestic uses	a	-1,840	-8,160	a	179 ^d
7. Surplus of sources over uses with the foreign sector	a	2,180	10,320	a	199 ^d
8. Total surplus of sources over uses of govt. funds	a	340	2,160	a	297 ^d

a No data available.

b Deflated by the index of investment prices, with the data weighted according to the sectoral distribution of credit (see Table XVIII-7).

c Deflated by the consumer price index.

d Deflated by the average of the index of investment prices (see footnote b) and the consumer price index.

SOURCE: Bank of Israel estimates.

downward. Even so, the ratio of medium- and long-term credit to total nondwelling investment was still high: about 70 percent in industry and 98 percent in agriculture; if we add investment grants, the ratios are about 80 percent in industry and more than 100 percent in agriculture.² The high rate of financing and its large subsidy component (about half the total credit in 1978) contributed to the continued overinvestment in sectors receiving such credit.

In light of the resurgent demand for housing, and especially of the skyrocketing of home prices, this credit item shot up 68 percent, but still fell short of the rise in home prices. In addition, total housing starts and purchases grew by about 20 percent, so that the average rate of financing dropped by 22 percent, as against a rise of about 40 percent last year.

During the year the interest rate on the various types of subsidized credit was raised by about 5 percentage points. The biggest changes were in the credit terms for industry, tourism, and agriculture at the beginning of the last quarter, when announcement was made of the intention to introduce a floating interest rate system with the goal of delimiting the subsidy element in credit; that is, when inflation is running at an annual rate of 10–40 percent, half this rate would be added to the basic interest, with a certain preference being shown to agriculture. At this stage it is not yet clear how this scheme will function in practice. This change is likely to decrease the subsidy element of credit by about 20 percent. Another change is the doubling of the period of the credits, from the previous average of about 5 years to 10–12 years. This will increase the subsidy component by about 20 percent, and will diminish the future flow of receipts of the capital market institutions from credit repayments, which are a prime source for financing domestic investments. On balance, the proposed change would leave the subsidy component of credit at its previous level (about 40–50 percent, according to the inflation rates which have prevailed in recent years).

The weight of medium- and long-term credit extended other than through the system of institutions surveyed here – i.e. through the commercial banks from lines of foreign credit (most of which carries exchange rate insurance) and by the government through other channels – rose from 25 percent of total credit in 1977 to 30 percent this year (see Tables XVIII-2 and XVIII-3). It would seem that the government's involvement in this type of credit is greater on the microeconomic level; but, on the other hand, the multiplication of channels and schemes for extending credit is liable to make overall control and direction more difficult for the public sector.

² The reference is to financing of investments in agriculture and not to the total investments of the agricultural sector. In the latter category the rate of financing is presumably lower.

TABLE XVIII-2

**MEDIUM- AND LONG-TERM CREDIT GRANTED BY THE
CAPITAL MARKET INTERMEDIARIES, 1977-78**
(IL million)

	1977	1978	Percent annual increase
A. Total credit			
1. Total credit through the capital market system narrowly defined	13,110	19,670	50
2. Total credit from the govt. other than through the system narrowly defined	2,420	4,330	
3. Total foreign currency credit from earmarked foreign currency deposits in commercial banks ^b	2,000	4,000	
Total long-term credit	17,530	28,000	60
B. Total credit to the principal economic sectors^a			
1. Through the system narrowly defined	8,030	11,870	48
2. From the govt., other than through the system narrowly defined	1,320	2,170	
3. Credit in foreign currency from earmarked deposits	2,000	4,000	
Total credit to the principal economic sectors	11,350	18,040	59
C. Total credit to industry			
1. Through the system narrowly defined	3,700	5,460	48
2. From the govt., other than through the system narrowly defined	40	800	
3. Credit in foreign currency from earmarked deposits	500	1,000	
Total credit to industry	4,240	7,260	71
D. Total credit to agriculture			
1. Through the system narrowly defined	1,170	2,340	100
2. From the govt., other than through the system narrowly defined	190	120	
3. Credit in foreign currency from earmarked deposits	.. ^c	.. ^c	.. ^c
Total credit to agriculture (1)/(2)	1,360	2,460	81

^a Agriculture, industry, construction and services.

^b Due to lack of a regular and detailed method of reporting, and in view of amendment of the regulations in the last few years, these estimates are less reliable than the remaining data. The data on this component should therefore be regarded as downward biased.

^c No data are available on the volume of loans to agriculture from earmarked foreign currency deposits.

SOURCE: Bank of Israel estimates.

Table XVIII-10 presents the sources and uses of funds with respect to the government's medium- and long-term financial activity in 1977 and 1978. Part of the activity is a "mirror image" of the relations between the capital market intermediaries and the government, but there are also some transactions which are executed other than through this system. The principal conclusion to be drawn from the table is that in domestic financial transactions, the government had an excess of uses over sources (i.e. a deficit) of IL 8.2 billion this year, compared to only IL 1.8 billion in 1977. This deficit was financed by borrowing abroad, in the net amount of IL 10.3 billion and IL 2.2 billion in 1978 and 1977, respectively. It should be emphasized that the expansionary influence of the government's medium- and long-term financial activity is not to be measured merely by the excess of uses over sources; the subsidization component of the government's financial intermediation must be added, for the government mobilizes its financial means on linked terms and lends them at a subsidized interest rate without linkage.

I. OVERALL ANALYSIS

1. MEDIUM- AND LONG-TERM RESOURCES³

A. VOLUME AND COMPOSITION OF RESOURCES

In 1978 the public's savings through medium- and long-term financial channels grew by about 30 percent in real terms, compared to an all-time high of about 160 percent last year, and reached approximately IL 16 billion (see Table XVIII-6). At the same time, the amount of savings made available to the capital market institutions declined by about 6 percent in real terms,⁴ compared to a rise of 25 percent last year. There was also a drop in loan repayments. The trend this year differed from that in previous years, when the resources available to the system grew uninterruptedly.

The decline in the savings inflow was connected with both the decelerated growth of medium- and long-term financial savings and the reshuffling of the public's portfolio of medium- and long-term assets, which was mainly reflected by a proportionally greater ac-

³ An analytical description of the composition of the resources available to the capital market intermediaries can be found in the Bank of Israel Annual Report for 1977, pp. 463-67.

⁴ After deflating by the consumer price index. At the same time, medium- and long-term investment prices rose this year at an annual average of 65-80 percent (see Table XVIII-2). When we measure the savings at the disposal of the system relative to the purchasing power in terms of investments, the drop is therefore much more severe, amounting to 15-22 percent.

TABLE XVIII-3

**SOURCES AND USES OF MEDIUM- AND LONG-TERM FUNDS OF THE CAPITAL MARKET NARROWLY DEFINED
AND OTHER INTERMEDIATION, 1976-78**
(IL million, gross flow of funds)

	1976	1977	1978	Uses	1976	1977	1978
A. Capital market narrowly defined							
Savings of the public					Gross medium- and long-term credit to:		
1. Net household savings	6,580	12,000	17,780	1. Households	3,080	3,750	5,820
2. Linked long-term bank deposits	130	390	1,170	2. Agriculture	890	1,170	2,340
3. Securities (purchases less sales in secondary market plus net purchases of original issues) and deposits	-480	-1,880	-4,170	3. Industry	2,510	3,700	5,460
Total savings of the public	6,230	10,510	14,780	4. Construction	360	460	890
				5. Services (including electricity and nonprofit institutions)	1,350	2,700	3,180
Loan repayments from:				6. Local authorities	1,160	1,330	1,980
4. Households	1,460	2,370	3,020	Total credit	9,350	13,110	19,670
5. Business	3,340	6,180	8,840				
6. Local authorities	900	1,260	2,430	Net transfers to:			
Total repayments	5,700	9,810	14,290	7. Government	910	3,130	1,520
Other sources				8. Banking institutions	250	1,370	3,850
7. National Institutions (net)	260	200	450	Total transfers	1,160	4,500	5,370
8. Foreign sector (net) ^a	410	190	250	Net short-term uses (including cash and demand deposits)	1,110	2,020	1,230

9. Others	100	390	590	Excess of expenditures over income	1,180	2,180	4,400
Subtotal (7-9)	770	780	1,290	Dividends and other payments, net ^c	-100	-710	-310
Total sources of the system	12,700	21,100	30,360	Total uses of the system	12,700	21,100	30,360

B. Other intermediation

1. Foreign currency credit from earmarked deposits with commercial banks

10. Credit from abroad	b	2,000	4,000	9. To industry	b	500	1,000
				10. To other branches of the economy	b	1,500	3,000
				Total credit		2,000	4,000

2. Credit from the govt. other than through the capital market narrowly defined

11. From medium- and long-term govt. sources (including loan repayments)	b	2,420	4,330	To households	b	410	740
				To producing and consuming sectors	b	1,320 ^d	2,170 ^e
				To local authorities	b	510	940
				To National Institutions	b	180	480
				Total credit		2,420	4,330
Total sources	b	25,690	32,520	Total uses	b	25,520	38,690

^a Includes short-term transactions of the intermediaries with the foreign sector.

^b Unknown.

^c Mainly in connection with general business transactions.

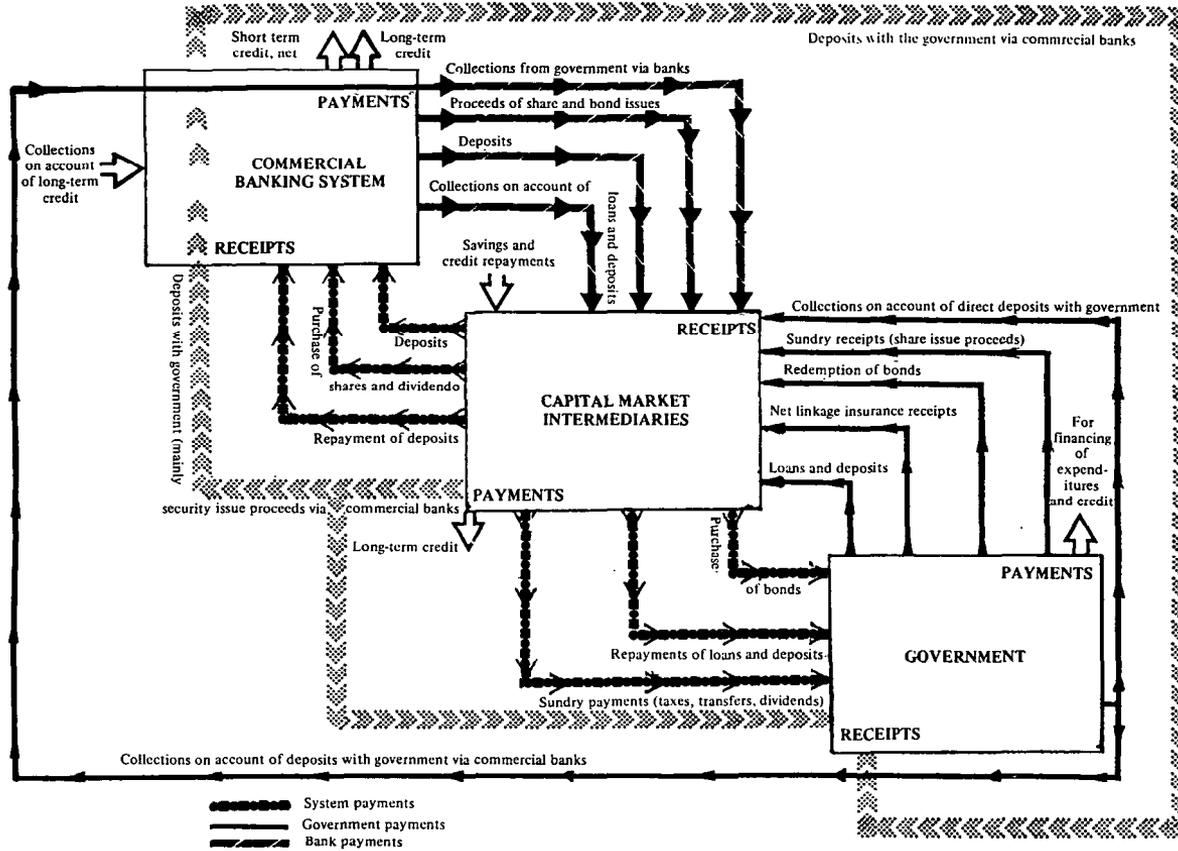
^d To industry IL 40 million, agriculture IL 190 million, construction IL 240 million, and services IL 850 million.

^e To industry IL 800 million, agriculture IL 120 million, construction IL 190 million, and services IL 1,060 million.

SOURCE: Bank of Israel estimates.

FIGURE XIX-1

MUTUAL RELATIONS BETWEEN CAPITAL MARKET INTERMEDIARIES AND THE GOVERNMENT AND COMMERCIAL BANKS



cumulation through channels outside the system.⁵ On the other hand, the real volume of loan repayments is influenced not by current decision but by the total amount of loans granted in previous years and their terms, as well as by the rate of price rise, which accelerated this year. In addition, the decline in the real volume of resources grew sharper as a result of the exceptionally steep rise in investment prices, which far eclipsed the increase in the consumer price index or wages.

Along with the shrinkage of resources available to the capital market narrowly defined, there was a stronger growth this year in two sources which previously were of only marginal importance in financing medium- and long-term activity: government credits extended through the system, and medium-term foreign currency credit⁶ given by the commercial banks from lines of credit abroad. The amount of financing provided by these two sources increased this year by 5–15 percent in real terms and reached IL 8.3 billion. It seems that in these two categories direct government intervention plays a more dominant role in allocating funds to the various firms than in the case of financing through the capital market intermediaries.

The total amount of loanable medium- and long-term funds at the disposal of the system broadly defined declined this year by 10–15 percent, in terms of the purchasing power of dwelling and nondwelling investment.

In the course of the year the ratio between total financial transactions of the system narrowly defined and its medium- and long-term credit outflow continued to grow, standing at 6.0 compared with 4.9 last year and 3.8 in 1976.

This large gap can be mainly attributed to the multistage financial intermediation process, which does not contribute to a more efficient capital market and does not further the public sector's control over the resources which it subsidizes.⁷ The widening of the gap this year was mostly connected with the much larger redemption of bonds and repayment of deposits, as well as with new bond issues and the receipt of new deposits. The growth of the gap in 1978 partly reflected a further increase in the multistage intermediation process, especially the granting of credit and to a lesser extent the mobilization

⁵ The ratio between the sources of funds of the system narrowly defined originating in the public's savings and the total accumulation of such savings in medium- and long-term channels was about 130 percent in 1977, and dropped to 93 percent this year.

⁶ The bulk of this credit carries exchange rate insurance borne by the government.

⁷ Because of the specialization of primary and secondary intermediaries, it is reasonable to expect some differential between total transactions and the credit outflow but not of the dimensions found in the Israeli economy, and certainly there is no need to increase the ratio, as has happened in recent years.

TABLE XVIII-4

**GROSS MEDIUM- AND LONG-TERM CREDIT AND CAPITAL MARKET
TRANSACTIONS^a OF THE SYSTEM NARROWLY DEFINED, 1976-78**
(IL million)

	1976	1977	Total	1978	
				1st half	2nd half
1. Intrasystem financial transactions	11,930	26,280	48,920	19,050	29,870
2. Financial transactions with other sectors (receipts)	23,450	38,460	69,020	26,620	42,400
3. Total financial transactions (receipts) (2+3)	35,380	64,740	117,940	45,670	72,270
4. Gross medium- and long-term credit	9,350	13,110	19,670	9,200	10,470
5. Ratio between gross credit and total transactions (3)/(4)	3.8	4.9	6.0	5.0	6.9

^a Medium- and long-term financial transactions only.

SOURCE: Bank of Israel estimates.

of savings, and in part it also stemmed from a decline in the weight of credit provided to the various economic sectors by the system.

In the composition of resources the weights of saving and loan repayments have remained stable for the past several years, but this does not imply any causal relationship; the fact is important only for understanding the structure of the system's resources.

The regulation of the demand and supply of credit is reflected only to a very limited degree by changes in interest rates, and to a greater extent in the government's rationing of credit and determining the amount of funds which it absorbs from the system. The net credit outflow to the government declined substantially this year, and stood at about IL 1.5 billion.⁸ This was related to the rise in the government's share of the bond issues floated by financial institutions which helped to compensate the system for the smaller volume of resources available to it in 1978. The amount of credit provided by the government other

⁸ Net transfers to the government are smaller than indicated by the data on the system, since some of the financial institutions execute linkage insurance with the Accountant General through commercial banks. Accordingly, net receipts from the government arising from such transactions do not appear in the data.

TABLE XVIII-5

FLOW OF FUNDS BETWEEN THE SYSTEM AND THE GOVERNMENT AND BANKING INSTITUTIONS, 1976-78
(IL million)

		Receipts o/a long-term assets ^a	Payments o/a long-term liabilities ^a	Surplus of current re- ceipts over payments (1-2) (3)	Current long-term receipts ^b	Current long-term payments ^b	Surplus of cur- rent receipts over pay- ments ^b (4-5) (6)	Total surplus (3+6) (7)
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
Government	1976	4,230	690	3,540	2,630	7,080	-4,450	-910
	1977	8,130	1,230	6,900	4,920	14,950	-10,030	-3,130
	1978							
	Total	18,920	2,820	16,100	8,910	26,530	-17,620	-1,520
	1st half	7,210	1,110	6,100	4,180	9,290	-5,110	990
	2nd half	11,710	1,710	10,000	4,730	17,240	-12,510	-2,510
Banking in- stitutions	1976	670	860	-190	2,050	2,110	-60	-250
	1977	350	1,440	-1,090	1,660	1,940	-280	-1,370
	1978							
	Total	750	1,420	-670	1,680	4,860	-3,180	-3,850
	1st half	310	660	-350	820	1,280	-460	-810
	2nd half	440	760	-320	860	3,580	-2,720	-3,040

^a Deposits, loans, and securities (including interest and linkage differentials received and paid). In the case of the government col.1 consists mainly of repayments of past deposits by the Accountant General and col.2 of repayments of deposits of the Accountant General with the capital market intermediaries.

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

SOURCE: Bank of Israel estimates.

than through the capital market intermediaries grew this year; this reflected a change in the credit channels but not in the government's total absorption (see section 2(b)).

In contrast to the decline in the net amount of funds transferred to the government, there was a significant rise in net transfers to the banking system: IL 3.9 billion compared to only IL 1 billion last year. Most of the increment derived from the increased share of the accumulation in savings schemes, especially linked long-term accounts, which was not invested in bonds (IL 2.2 billion this year compared to IL 0.6 billion last year), as well as from the purchase of bank shares by financial institutions (nearly IL 1 billion as against some IL 500 million last year). It should be noted that that portion of savings scheme deposits that is not invested in bonds is generally used for granting index-linked medium- and long-term credit to the government and the producing and consuming sectors.⁹

The overseas sector plays an important role in funding medium- and long-term domestic investments. Part of this financing flows directly through the capital market intermediaries (IL 4.25 billion this year, compared to IL 2.2 billion in 1977), and part through government sources (see section 3 (b)).

B. MEDIUM- AND LONG-TERM SAVINGS OF THE PUBLIC

The net total of the public's savings through the system decreased this year in real terms¹⁰ by about 6 percent, after a 25 percent rise last year. If the growth in savings is deflated by the index of nondwelling investment prices, the decline is much more precipitous — 15–20 percent. As against this, if we add share issues to the public and the sharply lower net redemption of government bonds, then the public's accumulation in medium- and long-term channels¹¹ increased by about 30 percent in real terms in 1978 to reach nearly IL 16 billion. It should however be emphasized that last year the growth rate was much steeper — a resounding 130 percent — though this came after a significant drop in 1976 (see Table XVIII-6). The accumulation in these channels was over and above the rapid rise in various types of liquid assets and physical investments, and was made possible primarily by the availability of financing, and to a lesser extent by the real increase in private savings from all sources (5–7 percent).

⁹ Medium- and long-term credit to the private sector and local authorities extended by the commercial banks is recorded as part of the nondirected credit given by the system. Therefore the figures for medium- and long-term credit in this chapter are somewhat understated, while the figure on commercial bank credit, which is regarded as short-term finance, has an upward bias.

¹⁰ Deflated by the average annual rise in the consumer price index. In this section the adjustment for the rise of prices has been made according to this index unless otherwise specified.

¹¹ Although the public's bond holdings are a highly liquid asset.

Among the institutional savings channels, the 20 percent real expansion of the social insurance funds, which brought the level up to about IL 7 billion, is deserving of note. The gain was led by the provident funds, which grew at a real 30 percent rate, whereas the pension and severance pay funds failed to move ahead, and in fact even retreated slightly.

Approved savings schemes maintained their primacy as the largest component among medium- and long-term savings channels, but their accumulation fell at a real 5 percent rate, and amounted to IL 8.1 billion during the year. But it should be remembered that this occurred after a year of unprecedented growth (73 percent in real terms). Taking the two years together, the accumulation in these two major channels (social insurance funds and savings schemes) grew at a very similar average rate. In the case of the savings schemes there was a strong expansion in the first half of the year, chiefly as a result of the special campaign by the commercial banks, which made cheap short-term credit available for deposit accounts. In addition to some increase in the return to the saver, the import of the campaign lay in the obligation assumed by the depositor to save for a number of months in this framework, with the full amount of the savings recorded at the time the credit was received (that is, during the first half of the year), together with the extension of credit in a corresponding sum to the government and/or to the capital market institutions.

The difference between savings schemes and bank provident funds as financial investment instruments seems to be diminishing in recent years, though it has not completely disappeared. The lessening of the gap stems, on the one hand, from the lengthening of the period of approved savings to six years (as part of an attempt to introduce schemes for longer periods, even up to possibly 12 years), from the reduction of the liquidity of the investment by imposing a minimum holding period of two years, and from the stiffening of the penalty for premature withdrawal; on the other hand, the rise in the average length of membership in provident funds, and the possibility of receiving credit up to the amount of the deposit have increased the liquidity of provident fund deposits. The investment period has remained 15 years (on the average seven and a half years), and in view of the income tax concessions on deposits in social insurance funds, the return on provident funds is still higher than that on savings schemes, even if their liquidity is lower.

Household savings through mutual funds continued to decline at a rather rapid real rate for the third year in a row, and amounted to about IL 1.3 billion. All the incremental investment took place in the second half of the year, together with the resurgent demand for index-linked bonds.

Life insurance has proved to be the most stable of all medium- and long-term savings channels. This is apparently due in large measure to the nature of this form of accumulation, which is based primarily on current payments only (i.e. with no initial or lump-

TABLE XVIII-6
MEDIUM- AND LONG-TERM SAVINGS BY THE PUBLIC, 1976-78
 (Flows of funds, in IL million)

	1976	1977	1978			Percent annual nominal increase			Percent annual real increase		
			Total	1st half	2nd half	1976	1977	1978	1976	1977	1978
A. Household savings											
1. Social insurance funds, net ^a	2,160	3,850	6,940	(2,850)	(4,090)	25	78	80	-5	32	20
2. Approved savings schemes, net ^a	2,460	5,730	8,130	(4,650)	(3,480)	12	133	42	-15	73	-5
3. Mutual funds, net ^a	1,340	1,510	1,290	(-80)	(1,370)	-20	13	-15	-39	-16	-44
4. Life insurance, net ^a	620	910	1,420	(690)	(730)	38	47	56	5	9	4
Total household savings	6,580	12,000	17,780	(8,110)	(9,670)	9	82	48	-17	35	-1
B. Transfers by the public (households and business)											
5. Linked long-term bank deposits	130	390	1,170	(450)	(720)						
6. Net purchase, sale and acquisition of securities and deposits ^c	480 ^d	-1,880 ^d	-4,170	(-3,160)	(-1,010)						
C. Total funds provided by the public to the capital market narrowly defined (A+B)	6,230	10,510	14,780	(5,400)	(9,380)	9	69	41	-17	25	-6
7. Net purchase of government bonds by the public	-4,450	-5,280	-1,700	(-3,070)	(1,370)						
8. Shares purchased by the public ^e	600	3,000	2,800	-	-						
D. Total medium- and long-term savings of the public	2,380	8,230	15,880	-	-	-	246	93	-	156	29

a Deposits (or premiums) less withdrawals of principal, interest, linkage differentials, and dividend (or claims).

b Savings schemes administered by commercial and mortgage banks or by other financial institutions specializing in savings for education purposes.

c Net sale of securities by the public in the secondary market, plus purchase of original issue securities deposited with the system, less redemption of securities by the system.

d Revised data.

e These figures are less reliable than the other data in this table.

SOURCE: Bank of Israel estimates.

sum deposits) over a period of many years. The life insurance fund grew by 4 percent in real terms this year to reach IL 1.4 billion.

Total household institutional savings amounted to IL 17.8 billion this year, which represents a zero growth in real terms, after a 35 percent advance in 1977.

Linked long-term deposits in commercial banks, which are placed for a minimum of two and a half years, increased this year to bring the total up to IL 1.2 billion. Most of the depositors are non-profit institutions and businesses, rather than households.

Net withdrawals by the public from the system, through purchases, sales, and redemption of deposits and securities, grew from IL 1.9 billion last year to IL 4.2 billion. This occurred despite the substantial decrease in net sales of securities held directly by the public, since the financial institutions were not allowed this year to issue bonds of the type purchasable by the public, while on the other hand there was a heavy redemption of option type bonds. As a result of this, the total amount of funds placed at the disposal of the institutions by the public reached IL 14.8 billion, compared to IL 10.5 billion in 1977 – a real decline of 6 percent.

The aforementioned factors significantly reduced the net redemption of government bonds this year from IL 5.3 billion in 1977 to IL 1.7 billion. This sum, together with the volume of share issues to the public, brings the total increase in the public's accumulation through medium- and long-term channels up to 29 percent in real terms.

C. LOAN REPAYMENTS

Debt repayment amounted to IL 14.3 billion this year; this represents 47 percent of the total resources at the disposal of the system narrowly defined and 57 percent of all its long-term uses,¹² similar to the figures in the last two years. The nominal size of this item is a function of the scope of credit granted in the past (the amount of loans, their terms, and the interest rates) and is not influenced by current developments in the capital market system.

However, the real importance of this source should be judged in the light of the development of investment prices; the faster prices rise, the smaller will be the contribution of this source to the financing of the system (and the subsidy component of credit will increase accordingly).

The quantitative importance of this source obligates those formulating policy for encouraging capital investments and methods of subsidizing them (and especially when fixing loan periods and interest rates) to carefully weigh the repercussions of the policy

¹² Gross medium- and long-term credit and net transfer of resources to the government and banking institutions.

steps on the total resources which will be made available to the system to finance future investments. The continual raising of nominal (though not real) interest rates and the reduction of the average period for various types of credit given in the past (principally mortgage credits and loans to provident fund members) go some way to explain the increase in repayments. As against this, while interest rates continued upward this year (see section 2(a)), the repayment period for credit supplied to industry and the tourist trade as well as for a number of other purposes was doubled from an average of about 5 years to 10–12 years. This is liable to decrease the contribution of this source of financing in the future, making it necessary to find alternative sources at the expense of other uses or to slow the growth of investments. It is not at all clear where firms will direct the additional funds remaining in their hands.

2. CREDIT TERMS AND DESTINATIONS

A. CREDIT TERMS

Most of the credit extended by the system for medium and long terms is cheap credit granted according to public sector directives and at its expense. This applies chiefly to funds supplied to households, industry and agriculture, but also to part of the services sector. A small part of the credit is given on a linked basis, mainly to local authorities and to those sectors of the economy whose investments are not on the public sector's high-priority list. This year too saw a continuation of the upward trend in nominal interest rates on credit extended at the direction of the public sector for various uses. At the same time part of the credit provided to the various sectors was shifted from one method to another: from that in which the interest rate is set for the entire period of the credit to a floating rate system, which permits a partial linkage of the nominal interest rate to the pace of inflation during the period of the loan. At the beginning of 1979 discussions were going on over the extension of the latter method to mortgage credit as well.

During the first seven months of 1978 there was no change in the terms of directed loans to industry; the (fixed) interest rates ranged between 17 and 22 percent (according to the location of the enterprise and the destination of its output), while the repayment period continued to be five years for equipment and eight years for structures. Beginning in August, and along with the change in the law for the encouragement of Capital Investments (see below), the terms for new loans to industry and tourism were revised. In view of the sharpening of inflation in the short run and a predicted slowing of the pace in the future, the setting of interest rates on development loans in advance was discontinued in favor of the floating method. The rate will be fixed by the government at the beginning of each year according to a formula, whose principal elements are a basic interest of

7–12 percent (depending on the location of the enterprise), plus half the expected inflation rate above the first ten percent, up to a ceiling of 27–32 percent (corresponding to 40 percent inflation). For the period until the end of 1978 interest was set at 19–25 percent, depending on the location of the enterprise.¹³ Likewise, the maturity of industrial credit was extended to 10–12 years for the entire loan (covering investment in equipment and structures).

The significance of these changes is the declared intention to create some link between the interest rate and the inflation rate, so as to delimit the subsidy component of credit. But the substantial lengthening of the repayment period is apt to increase the total subsidizing for a given amount of credit while reducing the annual repayment, thereby affecting the intermediaries' sources in the future. These two changes cancel each other out, and the rate of subsidizing credit for investments in equipment remains at about 50 percent, based on the inflation rates of recent years.

In other types of cheap industrial investment financing (principally supplementary funding and exchange rate or indexation insurance) the interest rate was also raised, by about 5 percentage points, but in this category the setting of a uniform nominal interest rate for the entire period of the loan was not modified.

The amended Law for the Encouragement of Capital Investments and the related arrangements provide *inter alia* for the broadening of eligibility for approved enterprise status, a 25 percent reduction in company tax for approved enterprises, and a considerable easing of administrative procedures.

In agriculture, as in industry and tourism, there was a shift to the floating interest system. The interest rate for the period to the end of 1978 was set at 22 percent, the intention being to adjust it yearly according to a basic interest rate of 9 percent, plus half the forecast inflation rate. Agricultural investment credit is granted for 5–10 years, and in certain exceptional cases for 12 years.

Directed mortgage credit is also unlinked and bears interest ranging between 10 and 40 percent, depending on regional locations, priority group, price of the dwelling, etc. According to Central Bureau of Statistics data the average interest rate rose progressively to reach 14 percent by the end of the year for directed mortgage loans (about 70 percent of all mortgages) and 39 percent for undirected mortgages (about 30 percent of the

¹³ Since the interest ceiling is fixed in advance at the beginning of the year, based on forecasts of price rises, there is reason to believe that the actual interest rate may be lower than justified. In 1978, for example, the interest ceiling for zone C (the central district) was set at 25 percent, whereas it should have been 31 percent according to the actual rate of inflation. Around the middle of 1979 there is an evident trend to increase the linkage to the interest rates required under the formula adopted.

TABLE XVIII-7

GROSS MEDIUM- AND LONG-TERM CREDIT GRANTED BY THE CAPITAL MARKET NARROWLY DEFINED, 1976–1978
(IL million)

	1976 ^a	1977 ^a	1978			Percent annual increase								
			Total	1st half	2nd half	Nominal credit			Real credit			Prices (annual average)		
						1976	1977	1978	1976	1977	1978	1976	1977	1978
A. To households	3,080	3,750	5,820	2,530	3,290									
1. Mortgage credit	2,110	2,180	3,990	1,750	2,240	13.4	12.7	67.6	0.8	4.8	-6.9	12.4 ^b	7.5	80.0
Directed	(1,640)	(1,790)	(2,900)	(1,290)	(1,610)	2.5	9.1	62.0	-8.8	1.5	-10.0	12.4 ^b	7.5	80.0
Private housing	(470)	(590)	(1,090)	(460)	(630)	80.7	25.5	84.7	60.8	16.7	2.6	12.4 ^b	7.5	80.0
2. Other credit	970	1,370	1,830	780	1,050	83.0	41.2	33.5	39.4	4.9	-11.0	31.3 ^c	34.6	50.0
B. To main economic sectors	5,110	8,030	11,870	5,470	6,400									
1. Industry	2,510	3,700	5,460	2,450	3,010	52.1	47.4	47.5	21.6	5.7	-13.7	25.1 ^d	37.7	71.0
2. Agriculture	890	1,170	2,340	1,030	1,310	41.2	31.4	100.0	12.9	-4.6	25.8	25.1 ^d	37.7	59.0
3. Construction	360	460	890	390	500	5.8	27.7	93.4						
4. Services	1,350	2,700	3,180	1,600	1,580	48.3	100.0	17.7	15.0	40.7	-28.7	29.0 ^b	42.1	65.0
C. To local authorities	1,160	1,330	1,980	1,200	780	33.3	14.6	48.8	2.5	-15.7	-9.8	30.0 ^c	36.0	65.0
Total	9,350	13,110	19,670	9,200	10,470									

^a Revised data.

^b According to the housing price index, annual average.

^c According to the consumer price index, annual average.

^d Derived from constant-price investment data.

^e Derived from investment data for services and electricity.

^f According to the implicit price deflator for public investments.

SOURCE: Bank of Israel estimates.

total). On an annual average, the interest rate on all mortgage loans rose by about one-third to stand at 19 percent. It should be remembered that this credit is extended for long periods, so that should inflation slow down, the subsidization would be drastically reduced, and the future interest on mortgage credit could reach rather high real rates.

In addition to this, part of the mortgage credit for private housing, which is subject to certain price restrictions, is granted at the expense of the public sector on unlinked terms but at a relatively high nominal interest rate, which was raised during the second half of 1978 from 26–32 percent to 30–36 percent.

The acceleration of inflation (from about 40 percent on an annual average in 1977 to about 50 percent in 1978) increased the subsidy component of outstanding cheap credit. The escalation of inflation and the likelihood that it will not continue at such a high rate for long make it advisable to consider the improvement and extension of the floating interest regime to all types of medium- and long-term directed credit.

B. VOLUME OF CREDIT

In 1978 the total amount of medium- and long-term credit granted by the capital market narrowly defined and the supplementary arrangements (see the next paragraph) reached IL 28 billion,¹⁴ compared to IL 17.5 billion last year. The nominal amount of credit granted during the year was 60 percent higher than last year, but since the prices of the uses of this credit rose, on a weighted average, by 68 percent, there was a real decline of 5 percent. Dwelling investment expanded by about 6 percent, mostly in industry, agriculture, and electricity, which were up 16 percent; accordingly, the decrease in the level of nondwelling investment financing was even larger. Mortgage lending was up 70 percent in nominal terms, but in consequence of the soaring of home prices and purchases, there was a drop of more than 20 percent in the rate of financing.

The accelerated growth of two medium- and long-term sources which supplement the system of capital market intermediaries should be emphasized (see section 1 (a)): credit from government sources granted other than through the financial institutions, and credit in foreign currency (mostly with linkage insurance) given through the commercial banks from overseas lines of credit. The volume of lending by financial institutions specializing in long-term credit rose by about 50 percent this year to reach some IL 20 billion, while the total amount of credit granted through both supplementary sources rose by 90 percent to IL 8.3 billion (30 percent of all credit, as against 25 percent last year). In addition to the credit for financing medium- and long-term investments, the business of equipment

¹⁴There appears to be one component of medium- and long-term credit which has not yet been captured by our system; it is estimated at about IL 1 billion and is granted to the producing and consuming sectors.

TABLE XVIII-8

**MEDIUM- AND LONG-TERM CREDIT IN RELATION TO INDUSTRIAL
INVESTMENT 1976-78**
(IL million)

	Gross credit granted		Industrial investment at current prices	Rates of financing	
	By the system narrowly defined	Total medium- and long-term credit		(1)/(3)	(2)/(3)
	(1)	(2)		(3)	
1975	1,650	a	3,660	45	a
1976	2,510	a	4,210	60	a
1977	3,700	4,240	5,115	72 ^b	83 ^b
1978	5,460	7,260	10,490 ^b	52 ^b	69 ^b

^a No data available.

^b The investment data include public sector investments, which do not require financing from the capital market. Therefore the rates of financing are biased downward.

SOURCE: Columns 1 and 2 – Table XVIII-2; col. 3 – Chapter IX above.

leasing companies, which serve as a substitute channel for subsidized credit, shot up to nearly IL 500 million (during fiscal 1978/79).¹⁵ At this stage it is difficult to evaluate the significance of the conspicuous rise in the credit granted other than through the financial institutions, from the aspects of the sectoral and regional composition of the financing, the subsidization rate, etc., but the multiplicity of channels and types of credits certainly make it more difficult for the public sector to control the direction of subsidized credit.

This year there was some decline in the ratio of medium- and long-term credit to industrial and agricultural investments. Part of the drop may have reflected the quality of the investment estimates and the lagging of credit behind investments in a period of accelerated investment. In any case it is clear that the upward trend in the financing rate was arrested. The ratio between credit and industrial investments reached 70 percent in 1978 and 98 percent in agricultural investments. Adding investment grants brings the

¹⁵ Part of this activity is already included in the system, since the financing to leasing companies is obtained in the form of foreign currency credit from earmarked deposits in commercial banks.

TABLE XVIII-9

**MEDIUM- AND LONG-TERM CREDIT IN RELATION TO AGRICULTURAL
INVESTMENT, 1976-78**
(IL million)

	Gross credit granted		Investment in agriculture at current prices ^a	Rates of financing	
	By the system narrowly defined	Total medium- and long-term credit		(1)/(3)	(2)/(3)
	(1)	(2)		(3)	
1975	630	b	815	77	b
1976	890	b	1,110	80	b
1977	1,170	1,360	1,365	86	99
1978	2,340	2,460	2,505	93	98

^a Excluding land reclamation, afforestation, and drainage.

^b No data available.

SOURCE: Columns 1 and 2 – Table XVIII-2, col. 3 – Chapter IX above.

figures up to 77 percent for industry and over 100 percent for agriculture. A substantial part of this financing is not extended in accordance with the general criteria stipulated in the Law for the Encouragement of Capital Investments, but according to branch or specific arrangements.

There was very little change this year in the distribution of medium- and long-term credit: The relative shares of the producing and consuming sectors, households, and local authorities were 65, 24, and 11 percent, respectively. And this despite the change in the credit structure from the standpoint of the various channels and the disparate development of dwelling and nondwelling investment.

C. CREDIT TO HOUSEHOLDS

Most of the medium- and long-term credit given to household by and through the system is mortgage credit (about 70 percent), while the rest is given by social insurance funds and insurance companies to their members or consists of subsidized credit to new immigrants, students, and the like, as well as credit extended by employers to their workers at low interest. In light of the pickup in demand for private housing, and especially the extraordinary rise in its price, this credit item rose in 1978 by about 68 percent, compared to only 13 percent in the previous year. As against this, home prices shot up nearly 80 per-

cent while purchases increased by 21 percent, so that the proportion of the total price covered by such financing declined by 22 percent, compared to a rise of about 40 percent in 1977. The upward trend in the share of credit for private housing in total mortgage financing continued in 1978. This apparently reflects primarily the growing tendency to direct home buyers to the private market for their housing solutions and less to publicly sponsored projects, although the share of nonsubsidized credit also grew (about 10–15 percent of all credit for private housing). Over the last three years the share of mortgage credit for private housing in total mortgage financing doubled, reaching 27 percent in 1978.

The growth of credit to households other than for the purchase of homes dropped by about 11 percent in real terms this year, after a significant rise in the past two years. The total amount in 1978 was about IL 1.8 billion, of which 43 percent went to members of social insurance funds, and a further 43 percent or so was given to workers by their employers through the various financial institutions. The other 14 percent went to a number of groups which receive cheap credit through one scheme or another (see above).

D. CREDIT TO INDUSTRY AND AGRICULTURE

During 1978 credit to industry jumped by 71 percent to IL 7.3 billion.¹⁶ Since the index of industrial investment prices rose to a similar extent, there was no real growth in the credit outflow. But there was reversal of the industrial investment trend, the level moving up about 20 percent, after declines of 17 and 8 percent in 1977 and 1976, respectively. As a result of the slow rise in total credit relative to investments, the proportion of industrial investments financed by credit decreased from 83 percent in 1977 to 69 percent. The actual decline, however, may have been smaller, since a reversal of the investment trend is generally accompanied by an institutional lag in the provision of credit: it may be also that the estimates of industrial investment were biased downward last year. It should be remembered that under the Law for the Encouragement of Capital Investment the investor receives, in addition to credit, a grant ranging from 5 to 30 percent, depending on the location of the enterprise. The total of this grant reached nearly IL 1 billion in 1978, bringing aggregate industrial investment financing up to IL 8.3 billion; this represents about 80 percent of total investment, compared to roughly 100 percent last year.

Credit is granted to industry through a number of channels: one is development credit supplied either in accordance with the capital investments law or otherwise; another is supplementary financing, given under sectoral arrangements according to different criteria from those applicable to development credit; a third source is lines of foreign currency

¹⁶ The figure may be even greater, if the estimated share of industry in total credit from earmarked foreign currency deposits is higher.

credit from abroad, managed by the commercial banks; while a fourth, and smaller, source is government credit other than through the capital market intermediaries. Before the 1979/80 fiscal year the intention to abolish supplementary financing was announced, but the growth of equipment leasing firms is likely to work in the opposite direction.

Credit to agriculture was up 81 percent in 1978; due to the rise in investment prices in this sector (about 60 percent), the real credit increment amounted to 14 percent. There was a similar expansion of investments (about 15 percent), so that the ratio of credit to total investments remained almost unchanged at 98 percent.¹⁷

E. CREDIT TO THE REST OF THE ECONOMY

Unlike agriculture and industry, construction and some of the service branches are not very dependent on long-term public credit. This is largely attributable to the low priority which the authorities have accorded these branches (except for electricity and tourism). These branches thus finance their investments to a far greater extent from own means, commercial bank credits, or from overseas sources.

The total amount of credit granted to the rest of the economy (mainly electricity and tourism, but also other services and the construction industry) reached about IL 8 billion, compared to IL 5.7 billion in 1977; this represents a real decline of about 20 percent considering the rise in investment prices.¹⁸

Gross credit to local authorities (from the sources analyzed here) grew by about 60 percent this year, but since their repayments rose much faster (more than 90 percent), it seems there was a rolling of debts, while the net credit outflow was very small, and even declined in real terms.

3. GOVERNMENT INTERVENTION IN THE MOBILIZATION AND ALLOCATION OF MEDIUM- AND LONG-TERM FINANCIAL RESOURCES

A. GOVERNMENT INFLUENCE ON THE SYSTEM'S OPERATIONS

The degree to which the government determines the character and volume of the institutions' operations is far larger than the weight of the latter's direct financial trans-

¹⁷In agriculture there is an insufficiently clear differentiation between the sources and uses of working capital on the one hand and between long-term sources and uses on the other, so that it is more difficult to determine the significance of the ratio of long-term credit to total investments.

¹⁸If the weight of industrial credit in total credit from earmarked foreign currency deposits is larger, the total financing provided to the rest of the economy will be somewhat lower.

TABLE XVIII-10

**SOURCES AND USES OF FUNDS^a FOR THE GOVERNMENT'S MEDIUM- AND LONG-TERM FINANCIAL
TRANSACTIONS, 1977-78**
(IL million, gross flows)

Sources	1978	1977	Uses	1978	1977
A. Medium- and long-term local financial transactions					
1. Sale of government bonds			1. Redemption of government bonds		
(a) Voluntary	12,260	2,030	(a) Voluntary	11,490	4,050
(b) Compulsory	2,980	1,920	(b) Compulsory	2,530	2,230
2. Obligatory deposits of financial institution security issues	15,230	11,670	2. Repayment of obligatory financial institution deposits of security issue proceeds	9,940	4,480
3. Deposits of commercial banks and financial institutions of proceeds of other security issues, savings schemes, linked long-term deposits, etc.	3,970	1,300	3. Repayment of commercial bank and financial institution deposits of proceeds of other security issues	480	110
			3a. Grants to investors in savings schemes reaching maturity (substitute for interest)	470	
4. Nonfinancial institution deposits with the Accountant General	150	50	4. Repayments of nonfinancial institution deposits with the Accountant General	-	-
5. Collection of matured deposits with financial institutions	2,740	950	5. Earmarked deposits in financial institutions	8,890	4,180
6. Direct repayment of credit (principal, interest, and linkage)	570	450	6. Credit provided directly and through commercial banks	4,330	2,420

7. Sale of shares and bonds from portfolio	50	20	7. Purchases of shares and bonds	190	280
7a. Dividends and interest on the government's security portfolio	80	100	8. Payments on account of exchange rate and linkage insurance	9,350	3,410
8. Exchange rate and linkage insurance premiums	1,480	830	9. Surplus (+) or deficit (-) of sources over domestic uses	-8,160	-1,840
Total domestic sources	39,510^b	19,320^b	Total domestic uses	39,510^b	19,320^b

B. Medium- and long-term financial transactions with the foreign sector

10. Loans from abroad			10. Repayment of loans from abroad		
Sale of bonds	6,250	3,010	Bonds	3,920	1,830
Government and international institution loans	15,350 ^c	270	Government and international institution loans	4,120 ^d	680 ^d
Banks and other loans	760	3,920	Bank and other loans	4,000	2,510
Total sources from abroad	22,360	7,200	11. Surplus (+) or deficit (-) of foreign sources over uses	10,320	2,180
			Total uses abroad	22,360	7,200
			12. Net transfers for financing nonfinancial activities of the government (residual) (9+11)	2,160	340
Total sources	61,870	26,520	Total uses	61,870	26,520

^a Includes financial items amounting to IL 8.9 million and IL 4.4 million net for 1978 and 1977 respectively, which are included in the government's domestic demand surplus.

^b In addition to this, national insurance deposits with the Account General reached IL 4,950 million and IL 2,000 million in 1978 and 1977 respectively.

^c Excludes U.S. government loans directly related to defense imports.

^d Net of repayment of U.S. govt. loans directly related to defense imports.

actions with the government. In fact, the government is involved in the entire financial intermediation process.

This applies to (a) the mobilization of primary sources of funds (chiefly household saving through provident and pension funds, insurance companies' approved saving schemes, and mutual funds); (b) the intermediate stage of financial intermediation, i.e. the onlending of most of the resources mobilized to secondary financial intermediaries through the purchase of bonds and placing of deposits for loan purposes by the primary financial intermediaries; and (c) the final stage, i.e. the channeling of funds to the producing and service sectors of the economy and to households for financing production and consumption.

In stage (a) 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 permits them to guarantee a real return of up to 5 percent on long-term saving, regardless of the rate of inflation, besides granting income tax concessions on earnings from this source, and in some cases on the initial deposits as well. This in effect has prevented the development of a capital market worthy of its name alongside that discussed here, one that could compete with it in raising funds from domestic sources. At the same time government intervention has undoubtedly had a very positive impact on the level of savings in the economy, especially in periods of high inflation.

As for stage (b), by requiring the primary financial intermediaries to devote between 80 and 92 percent of their resources to the government and financial institution acquisition of bonds (considered a recognized investment for purpose of the regulations), the government assures that most of the funds mobilized go to the purchase of financial institution bonds as well as its own issues.

In stage (c) the government's influence is reflected in the fact that most of the funds originate in government deposits (redeposits of bond issue proceeds placed with the Accountant General as a means of guaranteeing maximum government control over the use of the funds mobilized) or from bond issues accorded "recognized investment" status for the purpose of the investment regulations applicable to primary financial intermediaries. The government uses its powers to influence the system, and indirectly channels the bulk of the institutions' funds, in conformity with national development policy. It makes loan capital available at relatively low interest rates 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 providing soft loans in accordance with government directives. The deposit terms take into account the terms on which the credit is to be extended, as well as the institutions' guaranteed profit margin (see below).

In other words, most of the medium- and long-term financing provided by the institutions consist of cheap credit granted in accordance with government directives and subsidized by it. Even the relatively small share of the institutions' bond issue proceeds which could be defined as free of government control constitutes for the most part the institutions' contribution to the subsidized credit funds or is directly deposited with the Accountant General because of the institutions' desire to assure Treasury coverage of the linkage differentials.

The government also directs most of the medium- and long-term foreign currency credit given from earmarked deposits. This is in line with its policy of determining the purposes for which subsidized credit is to be used.

The institutions also transact some autonomous medium- and long-term credit business (on a relatively modest scale) with monies obtained mostly from provident and pension funds, insurance companies, and approved savings schemes (voluntary purchases of securities), as well as from business concerns and various other sources. The size of these resources largely depends on monetary developments and the liquidity situation of the economy.

B. SOURCES AND USES OF FUNDS FOR MEDIUM- AND LONG-TERM GOVERNMENT FINANCIAL ACTIVITY

In addition to the capital market intermediaries, the government, as already mentioned, determines the use of credits given by commercial banks from earmarked foreign currency deposits by providing exchange rate insurance. The government itself conducts a considerable amount of medium- and long-term financial intermediation, both between surplus and deficit units in the economy and between such units and the foreign sector.

In analyzing public sector activities, it is customary to examine the "classic" activities of the central government in order to determine its contribution to the domestic demand surplus, while most of its financial activities do not find expression in this analysis. Table XVIII-10 presents the sources and uses of funds for the government's medium- and long-term financial activity in 1977 and 1978. It will be seen that in 1978 the excess of uses over sources (i.e. the deficit) amounted to IL 8.2 billion, compared to only IL 1.8 billion the year before; this "deficit" was more than covered by IL 10.3 billion and IL 2.2 billion in net foreign credit 1978 and 1977, respectively. It should be emphasized that the expansionary influence of the governments' medium- and long-term financial activity is not measured merely by the excess of uses over sources; account also has to be taken of the subsidy component of the financial intermediation of the government which raises funds on linked terms and loans them out at a subsidized interest rate.

A substantial part of the government's financial activity presented in Table XVII-10 is a mirror image of the system's activity presented in previous chapters. Some of the

government's financial transactions, however, are not carried out through the system, but are conducted either directly with various economic units in Israel and abroad or through the commercial banks. It does not seem to be desirable to consolidate the presentation and analysis of these two categories of transactions because of the difference in the set of underlying considerations.

II. COMPONENTS OF THE CAPITAL MARKET¹⁹

1. SOCIAL INSURANCE FUNDS²⁰

A. SOURCES AND USES OF FUNDS

The social insurance funds experienced a more sluggish real growth in their net accumulation this year — 20 percent compared to 32 percent in 1977 (see Table XVIII-11). The pension, severance pay and “other funds”, were responsible for the poorer performance this year, while provident funds continued to expand in real terms. In the case of the first three groups the slowdown resulted from developments in the wage sphere and an accelerated increase in payments to members.

Purchases of securities fell this year to about 90 percent of total net savings deposits, and to an even lower level in relation to total resources at the disposal of the social insurance funds. Together with this, there was a slightly faster increase this year in credit to fund members and other loans and in administrative and other expenditures.

1. Savings Flows

Provident funds, most of which are managed by commercial banks, continued to expand rapidly this year. These funds serve the general public, as opposed to company funds, whose membership is a function of the number of company employees and whose contributions are a function of the labor agreements and wage developments.

Contributions to provident funds increased a little more moderately than in 1977 (25 percent in real terms, compared to 29 percent last year), and amounted to roughly IL 7 billion. The growth rate for savings withdrawals fell more conspicuously (11 percent as against 23 percent in 1977), so that compared to last year accumulation was up 32 percent in real terms. This occurred despite the decelerated growth of gross private sector savings and the continued broadening of the array of savings media. This is the only type

¹⁹ For developments in mutual funds see Chapter XIX in this Report.

²⁰ A detailed description of the structure of the sector and the nature of its activity can be found in the Bank of Israel Annual Report for 1977, pp. 486 ff.

TABLE XVIII-11

SOURCES AND USES OF SOCIAL INSURANCE FUNDS, 1976-78
(IL million)

Sources	1976 ^a	1977 ^a	1978	Uses	1976 ^a	1977 ^a	1978
Net savings deposit ^b	2,160	3,850	6,940	Net transfers ^c	2,060	3,830	6,250
				Medium- and long-term credit	450	700	1,090
				Net short-term credit	130	120	150
				Net change in short-term uses			
				Others ^d	-180	-140	-100
				Surplus of expenditure over income and net purchase of real assets	160	160	560
Repayment of medium- and long-term loans	460	820	1,010				
Total sources	2,620	4,670	7,950	Total uses	2,620	4,670	7,950

^a Revised data.

^b Net of withdrawals and assuming that contributions to Severance Pay Funds are also household savings.

^c Net purchases of securities from original issues and in the secondary market.

^d Including the increase in outstanding short-term assets, less the increase in outstanding short-term liabilities and adjustment items.

SOURCE: 1976 - Bank of Israel estimates ; 1977 and 1978 - based on Central Bureau of Statistics data.

TABLE XVIII-12
FLOW OF SAVINGS, BY TYPE OF FUND, 1976-78
 (IL million)

	1976	1977	1978	Percent annual change		
				1976	1977	1978
Deposits						
Pension ^a	1,924	2,792	4,611	34	45	65
Provident ^b	2,126	3,703	6,955	44	74	88
Severance pay and others ^c	355	678	864	11	91	27
Total	4,405	7,173	12,430	36	63	73
Rate of real change in deposits ^d				4	21	15
Payments to members						
Pension	1,312	1,741	3,070	44	33	76
Provident	670	1,112	1,859	62	66	67
Severance pay and other funds	261	464	562		78	21
Total	2,243	3,317	5,491	49	48	66
Rate of real change in withdrawals ^a				14	10	11
Net accumulation						
Pension	612	1,051	1,541	17	72	47
Provident	1,456	2,591	5,096	36	78	97
Severance pay and other funds	94	214	302	48	128	41
Total	2,162	3,856	6,939	25	78	80
Rate of real change in net accumulation				-5	32	20
Total wage payments in economy	34,350	52,330	83,060	37	52	59
Total wage payments in economy less public and community services	23,140	33,880	53,870	39	46	59

^a Funds administered by the Histadrut (General Federation of Labor), companies, and commercial banks.

^b Bank-administered and company provident funds and severance pay funds and advanced study schemes.

^c Bank-administered central pay funds, company and Histadrut funds, and paid-vacation schemes.

^d Deflated by the annual average change in the consumer price index.

SOURCE: For 1977-1978 - based on Central Bureau of Statistics data.

of social insurance fund to show a real increase in savings (see Table XVIII-12), a fact which can be ascribed chiefly to the substitution effect and to a lesser extent to the factors influencing total private sector savings.

The pension funds recorded a faster increase in total deposits this year (10 percent in real terms, compared to 8 percent in 1977), despite the slacker growth of wage payments. Payments to members, however, were up 17 percent in 1978, after holding steady last year, so that the total accumulation edged down 2 percent in real terms.

The pension funds accounted for only 22 percent of the total accumulation in social insurance funds this year, as contrasted with 73 percent for provident funds. The remaining 5 percent was in the central severance pay fund and a number of other small funds.

The mounting share of the provident funds is apparently explained by their relatively high rates of return (there are tax concessions on both deposits and withdrawals and current investment in index-linked bonds yields a high return); in addition, such savings are reasonably liquid in the intermediate term. Also included in this group are advanced study schemes, where the rate of return and liquidity are higher still.

2. Use of Funds

In conformity with Treasury regulations, the social insurance funds invest the bulk of their resources in securities. Investments amounted to nearly 90 percent of the accumulation this year, compared to 99 percent last year. Most of the investments were made in index-linked bonds issued especially for social insurance funds, although the regulations allow them to invest in shares as well. This year the ceiling on shares was raised from 5 to 10 percent of the obligatory investment, with the proviso that the additional sum be invested in industrial enterprises.

As a rule the funds invest more than required by the regulations in index-linked bonds, though there are differences among the various types of funds.

Purchases of shares from new issues and in the secondary market amounted to IL 2.2 billion this year. Sales came to nearly IL 1.3 billion, so that the net investment was about IL 900 million, a substantial part of total new share issues this year (IL 5.5 billion).

Most of the freely disposable accumulation is used for providing credit, mainly to members of the funds and to employers, either directly or through the commercial banks. In the last few years the period of the credit has been curtailed (usually to two years), and there has also been a rise in its price. Net credit extended this year came to only IL 230 million, though the gross outflow was more than IL 1.1 billion.

B. ASSETS AND LIABILITIES

The structure of the social insurance fund sector and developments during the year are reflected in the combined balance sheet. Securities represent the principal component of

the sector's assets, and their weight in the balance sheet continued to rise, reaching 94.8 percent in 1978, more than legally required (92 percent). It should be remembered that this item includes not only investments in bonds, but also in shares and convertible securities. Credit to members and other loans continued downward in 1978.

On the liabilities side there was a decline in the weight of the pension reserve and a rapid rise in the other reserves. The share of the pension fund in current accumulation declined from 45.5 percent in 1976 to 41.3 percent this year, while that of the provident fund rose from 39.5 percent to 45.3 percent between these two years. It should be noted, however, that these figures do not fully reflect the relative weights of claims on pension and provident funds in the total financial assets of households, since the figure appearing in the balance sheet for the pension reserve almost certainly does not measure the full actuarial liability on account of members' claims.

2. INSURANCE COMPANIES

A. INCOME AND OUTGO OF THE LIFE INSURANCE BRANCH

Life insurance premium receipts grew by 55 percent this year to reach IL 2, 130 million, but in real terms the gain was only 3 percent, compared to 12 percent in 1977 (see Table XVIII-14). The decline in the growth rate occurred during a year when there was an accelerated expansion of life insurance business and a continued rise in the share of linked policies in total life insurance. The apparent contradiction between the two developments is explained by the fact that with respect to a large percentage the linked insurance premium payments are adjusted every six months,²¹ so that the sharpening of inflation toward the end of the year causes a lag in such adjustments.

In the whole range of savings channels, life insurance is one of the least liquid components, with no adequate compensation in terms of return. Today, in fact, no individual can buy linked life insurance without an element of savings. Were it not for this, the sums saved through life insurance presumably would shrink greatly, or the return on such savings would rise substantially.

Interest receipts and income from the investment of life insurance funds grew at a real 32 percent rate this year, compared to 21 percent in 1977, and totalled IL 3.4 billion. The faster rise this year and the high level attained can be credited to the expansion of business and the acceleration of inflation, with a small fraction resulting from the changed method of recording linkage differentials.

²¹ For policies written up to the beginning of 1975. Since then the values of the policies and premiums are adjusted monthly.

TABLE XVIII-13

COMBINED BALANCE SHEET OF SOCIAL INSURANCE FUNDS, 1976-78^a
(IL million)

	1976	1977	1978	Percentage distribution		
				1976	1977	1978
Assets						
Securities	36,350	60,750	103,060	92.5	94.5	94.8
Loans to members ^b	1,020	1,270	1,770	2.6	2.0	1.6
Deposits and loans to others	820	970	1,550	2.1	1.5	1.4
Fixed assets	240	290	780	0.6	0.5	0.7
Employers' debt	250	330	430	0.6	0.5	0.4
Accrued interest and linkage increments receivable and other current assets	600	650	1,100	1.6	1.0	1.1
Total assets	39,280	64,260	108,690	100.0	100.0	100.0
Liabilities						
Pension reserve	17,860	27,700	44,860	45.5	43.1	41.3
Provident reserve (and advanced study schemes)	15,510	26,990	49,210	39.5	42.0	45.3
Severance pay, social benefit, and other reserves	4,520	6,720	11,160	11.5	10.5	10.3
General and other reserves	50	130	260	0.1	0.2	0.2
Auxiliary reserve and undistributed profits	1,180	2,370	2,640	3.0	3.7	2.4
Current liabilities	160	350	560	0.4	0.5	0.5
Total liabilities	39,280	64,260	108,690	100.0	100.0	100.0

^a Linkage differentials are included in the relevant balance sheet items.

^b Directly and through banks.

SOURCE: Central Bureau of Statistics.

TABLE XVIII-14

**INCOME, OUTGO, AND ACCUMULATION OF LIFE INSURANCE
COMPANIES IN ISRAEL^a, 1976-78**
(IL million)

	1976	1977 ^b	1978
1. Income			
Premiums	910	1,370	2,134
Interest	225	320	630
Total	1,135	1,670	2,764
2. Outgo			
Benefits to policyholders	292	462	714
Agents' commissions	132	195	315
Other current expenses	130	198	355
Gross profit ^c	94	142	236
Total	648	997	1,620
3. Surplus of income over outgo	487	683	1,144
4. Income from investment of life insurance funds	776	1,412	2,793
5. Accumulation	1,263	2,095	3,937

^a Israeli and foreign insurance companies in Israel and Lloyd's agents; before deducting reinsurance abroad and net reinsurance in Israel.

^b Revised data.

^c Including profits of reinsurers abroad.

SOURCE: Bank of Israel calculations based on a preliminary survey of the Central Bureau of Statistics, for 1978, and on *Insurance in Israel*, Central Bureau of Statistics, for previous years.

Claims paid to policyholders were only slightly higher this year in real terms (about 3 percent), as were total expenses. As a result, accumulation was up by a real 27 percent, compared to 16 percent in 1977.

B. INCOME AND OUTGO OF THE GENERAL INSURANCE BRANCH

Premium receipts from general insurance was up about 55 percent this year, compared to some 50 percent in 1977; motor vehicle insurance accounted for the more vigorous increase while in other insurance the growth rate was about the same as last year (see Table XVIII-15). The past three years have witnessed fluctuations in the growth rates of these

TABLE XVIII-15

GENERAL INSURANCE PREMIUM RECEIPTS^a, 1976-78

	1976	1977 ^b	1978
	(IL million)		
Total general premium receipts ^c	2,437	3,652	5,666
Motor vehicle insurance	1,034	1,467	2,284
Other insurance	1,403	2,185	3,382
	Percent annual increase		
Total general premium receipts	45.4	49.9	55.1
Motor vehicle insurance	58.4	41.9	55.7
Other insurance	37.2	55.7	54.8

a Of Israeli and foreign insurers and Lloyd's agents.

b Revised data.

c Includes registration and policy fees, collection fees, and other payments collected from policyholders, including marine insurance and less reinsurance in Israel and imputed interest.

SOURCE: Bank of Israel calculations based on a preliminary survey of the Central Bureau of Statistics for 1978, and on *Insurance in Israel*, Central Bureau of Statistics, for previous years.

two main subbranches, but for the period as a whole they are similar (about 140 percent in nominal terms).

The number of motor vehicles grew to roughly the same extent as in 1977 (about 5 percent), but since vehicle prices shot up about 100 percent on an annual average in 1978, compared to around 50 percent in 1977, there was a large rise in insurance premiums. During the year the prices of housing, investments, and imported raw materials also increased at an accelerated rate, but its influence on premium receipts was not yet felt by year's end. Apparently insurance coverage is adjusted faster for inflation in the case of motor vehicles than for other classes of general insurance.

Most general insurance premiums are actually transfer payments, but a small percentage is accumulated and constitutes an addition to domestic savings, which is reflected in accumulation in the general insurance fund, and in part in the pending and approved claims item. The accumulation is used to provide credit and to purchase bonds on the open market.

TABLE XVIII-16

ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES, 1976-78

	IL million			Percent		
	1976	1977 ^a	1978	1976	1977 ^a	1978
Assets						
Government or government-guaranteed bonds	3,951	7,075	12,295	53.0	58.8	65.0
Other securities	120	194	294	1.6	1.6	1.6
Loans on policies	69	136	216	0.9	1.1	1.1
Other loans	1,068	1,216	1,558	14.3	10.1	8.2
Long-term deposits	104	178	342	1.4	1.5	1.8
Real estate and investment in subsidiaries	225	419	818	3.0	3.5	4.3
Outstanding premiums	629	919	1,457	8.4	7.6	7.7
Sundry debtors	718	941	1,094	9.6	7.8	5.8
Cash and demand deposits	574	957	840	7.8	8.0	4.5
Total assets	7,458	12,035	18,914	100.0	100.0	100.0
Liabilities						
Paid-up share capital	227	360	614	3.0	3.0	3.4
General and other reserves	308	751	1,307	4.1	6.2	6.9
Life insurance reserve (less reinsurance)	3,545	5,494	9,193	74.5	45.7	48.6
General insurance reserve (less reinsurance)	676	1,132	1,742	9.1	9.4	9.2
Extraordinary risks reserve	231	359	506	3.1	3.0	2.7
Deposits of reinsurers	350	552	526	4.7	4.6	2.8
Pending and approved claims	1,305	2,193	3,564	17.5	18.2	18.8
Current liabilities	816	1,194	1,435	11.0	9.9	7.6
Total liabilities	7,458	12,035	18,914	100.0	100.0	100.0

^a Revised data.

SOURCE: Bank of Israel calculations based on a preliminary survey by the Central Bureau of Statistics, for 1978, and on *Insurance in Israel*, Central Bureau of Statistics, for previous years.

C. ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES

The balance sheet of the Israeli insurance companies grew by 57 percent this year, compared to 61 percent in 1977, to reach approximately IL 19 billion (see Table XVIII-16). No economic significance should be attached to the change in the growth rate, because of a change in accounting practice last year.²²

Among the conspicuous changes in the composition of assets this year the continued rise in the share of bond investments should be noted, along with the further decline in other loans (which are generally given on a commercial basis, and not against policies). This development can be explained to some extent by the rise in the weight of the life insurance reserve in total liabilities. The share of sundry debtors and of cash and demand deposits also continued downward.

²² See the Bank of Israel Annual Report for 1977, pp. 499-500.