CHAPTER XIV

MONEY SUPPLY, CREDIT, AND THE BANKING INSTITUTIONS

1. Main Developments

Monetary expansion accelerated strongly in 1971, after beginning to pick up in the second half of the previous year. The money supply grew by IL 956 million, or 28.2 percent, as opposed to 14 percent in 1970; the increase in other liquid assets held by the public[1] came to IL 2,389 million, or 34.9 percent, compared with 23.2 percent in 1970.

The upward thrust in the year reviewed came from an improvement in the balance of payments current account, a larger inflow of capital, and the further deficit financing of the Government budget. While bank credit to the public rose substantially, the contribution of the monetary sector to the additional demand in the economy was small compared with that of the balance of payments developments and the Government's deficit budget.

The balance of payments developments were the predominant factor behind the 1971 growth of demand and liquidity. There was no increase in the nongovernmental sector's deficit on current account, but its unilateral transfers from abroad and its credit receipts soared. In addition, the devaluation of the Israeli pound and the revaluation of the German mark yielded large capital gains to owners of Pazak and Tamam foreign currency accounts, and there was some increase in conversions from these greatly expanded deposits (mostly from Pazak accounts held other than by restitution recipients).

Incomes and demand were augmented and liquidity infused on a considerable scale as a result of the increase in foreign investment, in transfers from abroad by immigrants and other individuals for financing the purchase of homes, other real estate, and consumer durables, as well as in institutional transfers, which were likewise intended for financing local purchases. Another factor in the growth of liquidity, also connected with the balance of payments, was the much larger volume of directed credit granted to exporters in the wake of the expansion of exports and the devaluation of the Israeli pound.

The large liquidity infusion was accompanied by a net accumulation of foreign currency assets at the Bank of Israel. Government financing of the State budget did not offset the inflationary effects of the nongovernmental sector's balance of payments; on the contrary, the Government's debt to the Bank of Israel rose by IL 1,422 million. An

1. Other liquid assets of the public are defined as time deposits in Israeli and foreign currency, approved saving schemes, and the Short-Term Loan.

Table XIV–1
ANNUAL CHANGES IN MAJOR MONETARY AGGREGATES, 1969-71
(IL million)

Year	Balance at end of year	Change in end-year balance		Annual average balance	Change in annual average balance	
		IL m.	%		IL m.	%
				Money supply		
1969	2,970	71	2.5	3,015	200	7.1
1970	3,385	415	14.0	3,167	152	5.0
1971	4,341	956	28.2	3,876	709	22.4
				Other liquid assets of the public[a]		
1969	5,547	991	21.8	5,035	972	23.9
1970	6,835	1,288	23.2	6,205	1,170	23.2
1971	9,224	2,389[b]	34.9	8,056	1,851	29.8
				Total liquid assets of the public[c]		
1969	8,517	1,062	14.2	8,050	1,172	17.0
1970	10,220	1,703	20.0	9,372	1,322	16.4
1971	13,565	3,345	32.7	11,932	2,560	27.3
				Bank credit to the public[d]		
1969	3,928	664	20.3	3,640	599	19.7
1970	4,741	813	20.7	4,270	630	17.3
1971	5,793	1,052[e]	22.2	5,270	1,000	23.4

[a] Time deposits in local and foreign currency, saving scheme accounts, brokered bills, and Short-Term Loan holdings.

[b] Includes IL 670 million in devaluation differentials on deposits linked to the exchange rate (Pazak) and foreign currency deposits (Tamam).

[c] The money supply plus other liquid assets held by the public. It is the increase in these two components that is referred to in this chapter as monetary expansion.

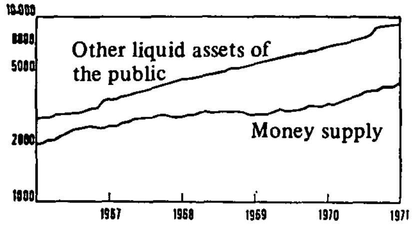
[d] Local and foreign currency credits from banking institutions and the Bank of Israel, including bill brokerage.

[e] Includes IL 215 million devaluation differentials on foreign currency credits.

analysis of Bank of Israel transactions with the Government indicates that the latter had a balance of payments deficit, i.e. foreign currency expenditure far exceeded foreign currency revenue. However, this failed to counteract the expansionary effects of foreign currency purchases from the nongovernmental sector, because of a big rise in Bank of Israel credit to the Government.

The external infusion stemming from the accumulation of foreign currency balances and the Government's deficit financing totalled IL 2,496 million in 1971, compared with IL 924 million the year before. This led to a big increase in the money supply and other liquid asset holdings of the public. This in turn swelled the liquid assets of the banking institutions, enabling them to meet the buoyant demand for bank credit and thereby accentuate the monetary expansion.

Figure XIV–1
MONETARY EXPANSION, 1967–71
(IL million)



In the face of these inflationary developments, the Bank of Israel adopted a series of measures to restrain monetary expansion and the growth of credit to the public. The required liquidity ratios on demand and time deposits were raised in May, June, and December 1971, and again in February 1972. The participation of the commercial banks in the Fund for Financing Export Shipments was increased in April and September, while the share of the Bank of Israel was reduced correspondingly. Net sales of the Short-Term Loan were brisk throughout most of the year, and especially so from August through October, after the yield was upped at the beginning of August. The raising of the interest rate on liquidity surpluses held at the Bank of Israel during the postdevaluation period also helped to curb the expansion of credit, as it diminished the readiness of the banking institutions to expand their credit business. The revision of the liquidity ratios added 10 points to that held against demand deposits – from 38.2 percent at the end of 1970 to 48.2 percent at the end of 1971 – and five points to the ratio maintained against time deposits.

Despite these measures, the money market was marked by an abundance of liquidity: the principal monetary aggregates (the money supply, other liquid assets, and credit to the public) advanced rapidly, and since May the banking institutions have had large liquidity surpluses. Both debitory and creditory interest rates rose in the second and third quarters of 1971, in spite of the increased liquidity. The raising of the yield on the Short-Term Loan and of the interest rate on liquidity surpluses doubtless prevented an even faster expansion of credit in the last quarter of 1971, and perhaps even a slight decline in interest rates.

That liquidity was so abundant in 1971 in spite of the absorptive measures taken by the central bank can be attributed to the inadequacy of the restraining fiscal steps and to the large increase in long- and medium-term directed credit granted by the Government and in directed export credit provided by the Bank of Israel. What was needed in 1971 was a fiscal policy that would counteract the inflationary pressures engendered by the accumulation of foreign exchange reserves. This became more urgent after the devaluation, when the inflow of foreign currency gathered momentum. The greater supply of Government-directed credit for financing investments and home purchases, along with the notable growth of directed Bank of Israel export credit, reduced the need for bank credit, thereby impairing the effectiveness of the monetary measures introduced.

In the absence of a comprehensive policy designed to ease inflationary pressures, the expansion of aggregate demand and the abundant liquidity drove prices sharply upward.

While this can be partly attributed to exogenous factors – namely the devaluation of the Israeli pound, the revaluation of several European currencies, and the higher cost of imports – the fact that since the second half of 1970 prices have gone up much faster than warranted by these factors suggests the existence of demand pressures.[2] This is confirmed by developments in the labor, real estate, and securities markets.

Analysis of the sources of monetary expansion in 1971 points up three outstanding developments. First, there was a rapid growth in IL time deposits, in line with a trend begun in the previous year. It is reasonable to assume that in the past two years a growing share of the liquidity needs of the economy was supplied by time deposits, and that this was at the expense of money holdings. Though the money supply expanded rapidly between the end of 1969 and the end of 1971, it nevertheless lagged behind the growth of economic activity (at current prices). Consequently, the raising of the interest rate on time deposits by one percentage point in April 1970 and by a further point in August 1971 presumably induced the public to reshuffle its portfolio of liquid assets. While the inflation of 1970 and 1971 reduced the real yield on unlinked assets, it affected savers' financial asset preferences only after the lapse of some time, since for a fairly long period the public did not expect a rapid price increase.

The second major development was the large capital gains enjoyed in 1971 by holders of Pazak and Tamam accounts in the wake of the devaluation of the Israeli pound and the revaluation of the German mark. During the six months that have elapsed since the devaluation there has been no increase in conversions of personal restitution funds, so it may be assumed that owners of such accounts have not yet fully adjusted their asset portfolios, apparently because they anticipate a further change in the external value of the mark.

The third development was a conspicuous slackening in the growth of approved saving schemes, despite the heavy demand for assets linked to the consumer price index. There was probably a further shift from such deposits to bonds and social insurance funds in which membership is voluntary (those for the self-employed).

2. The Influence of Monetary Developments on the Economy

The strong monetary expansion, which began in the second half of 1970 and became more pronounced in the course of 1971, greatly increased the annual average balance of the various liquid assets. The money supply grew by 22.4 percent in 1971, compared with only some 5 percent the year before, while other liquid assets held by the public went up by 29.8 percent, as against 23.2 percent in 1970. The monetary expansion was one of the principal causes of the swelling aggregate demand in the economy and the sharp rise of prices and wages. This stands out clearly when the sources of growth are analyzed.

The most striking feature of 1971 was the greater weight of external infusions (credit to the Government and the accumulation of foreign currency balances) and the smaller weight of bank credit to the public despite a sizable absolute increase. The amount of liquidity pumped into the economy by the accumulation of foreign currency balances at

2. See the discussion in Chapter VI, "Prices", section 2.

Table XIV–2

INDICATORS OF THE TURNOVER VELOCITY OF LIQUID ASSETS HELD BY THE PUBLIC, 1969-71

	Average velocity of demand deposits[a]	Annual average velocity relative to GNP[b]		
		Money supply	Other liquid assets[c]	Total liquid assets
1969	19.9	5.35	3.20	2.00
1970	21.5	5.99	3.06	2.02
1971	22.7	6.02	2.90	1.96
		Annual average velocity relative to the economy's resources[d]		
1969		6.55	3.92	2.45
1970		7.50	3.83	2.54
1971		7.40	3.56	2.40

[a] Total debits to local-currency demand deposits in banks, divided by the average annual volume of these deposits. Deposits with cooperative credit societies are not included.

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

[c] Consists of less liquid deposits of the public with banking institutions, bill brokerage, and Short-Term Loan certificates held by the public.

[d] The gross national product at current prices, plus the import surplus (both based on the effective exchange rate), divided by the average annual volume of the three aggregates.

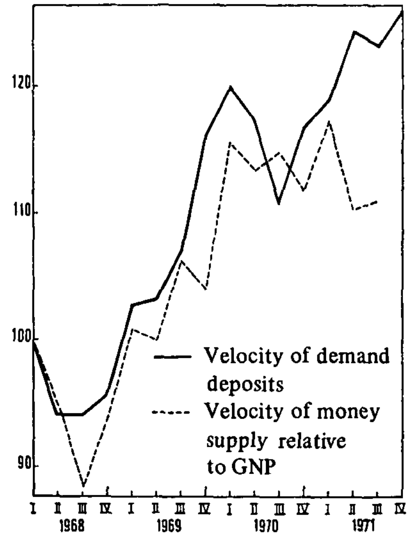
the Bank of Israel and Bank of Israel lending to the Government totalled IL 2,496 million in 1971, as contrasted with IL 924 million in the previous year (see Table XIV-3), while bank credit to the public expanded by IL 1,052 million after an increase of IL 813 million in 1970. These data suggest that the principal cause of monetary growth in 1971 was the large-scale liquidity infusion engendered by the expansion of capital imports and Bank of Israel lending to the Government.

The increased liquidity was a direct outcome of the improvement in the current account of the balance of payments, the jump in capital imports, and the appreciation of Pazak and Tamam deposits due to the devaluation of the Israeli pound and the revaluation of the mark. The effect of the notable export gain during the year was accentuated by the expansionary influence of Bank of Israel export financing. These balance of payments developments and the heavy Bank of Israel financing of the Government budget were the factors behind the rise in aggregate demand and the concomitant large-scale infusion of liquidity.

It follows that much of the incremental demand in 1971 came from sources whose expansion does not depend on the credit potential of the banking system – the public sector, exports, personal restitution payments and conversions of Pazak and Tamam funds, foreign investments, and other capital transfers from abroad. What is more, the incremental liquidity engendered by the expansion of these sources in 1971 enabled banking institutions to provide more nondirected bank credit to meet the heavier demand of business firms and households.

The composition of the monetary expansion also has implications regarding the effectiveness of the various instruments used in the conduct of a stringent monetary policy. The raising of liquidity ratios, the upping of the banking institutions' share in export financing, and the enhancing of incentives to hold liquidity surpluses can be an effective brake when external infusions are not excessively large.[3] But when foreign currency reserves policy and fiscal policy permit external infusions on a scale like that of 1971, the liquidity of economic units will grow even if restrictions are imposed on the expansion of bank credit.

Figure XIV–2
INDICATORS OF THE CIRCULATION VELOCITY OF THE MONEY SUPPLY, QUARTERLY, 1968–71



Another factor that requires the coordination of fiscal policy with foreign currency reserves policy relates to the ability of monetary policy to offset the expansionary effect of a growth in incomes and the public's wealth. Monetary policy affects the spending of the business and household sectors by altering interest rates and liquidity. The stronger pace of monetary expansion in 1971 was connected, as already mentioned, with the growth of incomes and wealth due to balance of payments developments. Under such conditions, the usefulness of the monetary policy instruments is circumscribed, particularly when the public anticipates a rise of prices (this further stimulates demand in the various sectors). Moreover, owing to the administratively-fixed interest rates on investment, export, and other types of directed short-term credit, as well as the volume of such credit, the monetary policy measures failed to retard the growth of aggregate demand. Interest rates on directed credit were not raised and more of it was available in the year reviewed, chiefly medium- and long-term credit for investment purposes. Monetary policy can hardly be expected to curb demand when the supply of medium- and long-term credit is expanding rapidly and its real cost declines because of mounting inflation.

There is another aspect of the existing export finance arrangements that militates against a stringent monetary policy in a devaluation year. Because a large proportion of the export financing (for overseas shipments, diamonds, and imports for export production) is provided in foreign currency, this automatically increases the volume of directed credit after a devaluation. Thus, even though the Bank of Israel reduced its participation in the export funds, the amount of credit it extended in 1971 rose by IL 142 million in IL terms because of the change in the exchange rate. This automatic expansion of credit

3. See the detailed discussion of the various monetary measures in section 3 below.

in the wake of a devaluation largely nullifies the influence of the latter in mopping up excess liquidity in the economy.

As already noted, it was the more abundant liquidity that permitted prices to soar in 1971, a development caused partly by the more buoyant demand and partly by the operation of exogenous factors. The import surcharge and the abolition of subsidies in 1970, the higher prices of imports, the devaluation of the Israeli pound, and the revaluation of several European currencies created pressure on the costs side. However, the actual rise of prices far exceeded that attributable to these factors, even assuming that all the extra costs were passed on to the customer. The mounting demand also led to steep wage hikes and accentuated the overemployment prevailing since 1970.

After a devaluation – official or unofficial – a certain rise in the price level is inevitable, and even essential if the aims of the devaluation are to be realized. But excessive price increases are not only undesirable in the postdevaluation adjustment process, they may actually erase the positive results of the devaluation because of their detrimental impact on imports and exports.

Despite the spiralling of prices and the growth of the national product and of resources available to the economy, the circulation velocity of the money supply declined fractionally relative to total resources and held steady relative to the national product (see Table XIV-2). The ratio of the national product and total available resources to the other liquid assets of the public declined even more than the circulation velocity of the money supply. This indicates that the strong inflation and the gain in the national product notwithstanding, there was excess liquidity in 1971 – a development also borne out by the liquidity surpluses run by banking institutions from the second quarter of 1971.

The raising of debitory interest rates in the second quarter of 1971 and the upping of the rates on time deposits in August do not conflict with the assumption of excess liquidity. These changes were due largely to the Bank of Israel's policy and to the sluggish response of the banking institutions to money market developments, and should not be viewed as an upturn in the price of money stemming from excess demand for liquidity.

Analysis of the monetary expansion in 1971 points to a shift from money holdings to other liquid assets (Israeli currency time deposits and the Short-Term Loan), reflecting the postdevaluation portfolio adjustment.

Despite the rapid expansion of the money supply in 1971, the liquidity preference might have been expected to increase even more, for several reasons: First, although the national product and total available resources at current prices expanded in 1971 at approximately the same rate as the annual average level of the money supply, in the two preceding years the growth of the latter had lagged behind that of economic activity. Thus it is reasonable to assume that in 1971 the economy's liquidity requirements exceeded the incremental means of payment. It will be recalled that real monetary balances fell steeply in 1969 and 1970: whereas the average annual level of the money supply went up 12.5 percent, total resources soared 43 percent (at current prices).

Secondly, 1971 saw a big increase in transactions that are not reflected by the data on the national product or total resources but nevertheless increase the demand for money. The reference is to the more vigorous activity in the real estate and securities markets. Trading in bonds was up 66 percent in 1971, and that in shares was double the 1970 volume. Real estate transactions and prices also rose, but no direct data thereon are available. It is difficult to quantify the effect of these developments on the demand for liquidity, but the experience of 1962-63 indicates that it can reach significant proportions.

It should also be noted that if the elasticity of demand for money relative to income is greater than unity, this should increase the ratio between the money supply and the national product. The circulation velocity of the money supply relative to the national product averaged 5.34 in 1960-65, compared with 5.94 and 6.02 in 1970 and 1971 respectively. Despite the notable growth of the national product between these two periods and the fact that during both economic activity was at a buoyant level, the circulation velocity was higher in the later period.

The increase in the velocity of demand deposits in 1971 (see Table XIV-2) indicates that the money supply was utilized more intensively, even though its circulation velocity decreased relative to total resources. This suggests that part of the economy's liquidity requirements was satisfied by interest-bearing assets – mainly Israeli currency time deposits and the Short-Term Loan. This would also explain the large growth of these assets during 1970 and 1971, when soaring prices rendered their real return negative. Apparently the rise of interest rates on less liquid assets in 1969-71 enhanced the preference for interest-bearing assets. This is indicated by the shortening of the average term to maturity of the Short-Term Loan, reflected by the growing weight of series of up to 90 days in the total value of certificates outstanding.[4]

Another factor behind the comparatively rapid increase in other liquid assets was the large capital gains on Pazak and Tamam deposits in 1971 stemming from the change in the exchange rate of the Israeli pound relative to the German mark. The profits accruing to holders of such accounts after the devaluation of the Israeli pound and the revaluation of the mark reached nearly IL 900 million, and presumably they had not completed the reshuffling of their portfolios by the end of 1971.

It should also be borne in mind that the revaluation of the mark was a gradual process that began in May, and the new rate was fixed only in the middle of December.[5]

4. The liquidity of IL time deposits depends on the arrangements in force between the banking institution and its clients concerning the "breaking" of such deposits. Deposits can always be withdrawn before the end of the six-month period, but it is difficult to determine the cost of premature withdrawal. Directives issued by the Examiner of Banks forbid any concessions in case of "breakage", but the extent of compliance is not clear.
5. The rate of the German mark continued to rise in the international money markets during the first quarter of 1972 – indicative of the prevailing feeling that the realignment of rates under the Smithsonian agreement of December 1971 is not final.

3. MONETARY POLICY AND THE LIQUIDITY OF BANKING INSTITUTIONS [1]

The foremost monetary development in 1971 was the large amount of liquidity pumped into the economy as a result of the accumulation of foreign currency balances at the Bank of Israel and the greater volume of credit it gave to the Government. This prompted the Bank of Israel to conduct a policy of liquidity absorption in order to curb the monetary expansion and the growth of credit to the public. Monetary policy was characterized from April 1971 by the intensive employment of various methods of absorption; nevertheless, the main monetary aggregates mounted rapidly (see Table XIV-1).

These external infusions added up to IL 2,496 million in 1971, as against IL 924 million in 1970. It should be noted that the 1971 figure includes IL 613 million in devaluation increments on foreign currency assets and the Government debt. Inclusion of these increments is justified, since they almost equal the appreciation of Pazak and Tamam deposits because of the devaluation of the Israeli pound, and this appreciation necessitated the introduction of measures to counteract the impact of the growth of their owners' asset holdings.

A sectoral analysis of the external infusions indicates that the nongovernmental sector was the source of the increase in foreign currency assets at the Bank of Israel. The adverse balance in the country's goods and services account attributable to the nongovernmental sector did not change in 1971, whereas its capital imports expanded considerably. This applies both to unilateral transfers – personal restitution, personal remittances, private investments, and immigrant transfers – and to foreign credit (most of it for financing imports of ships and aircraft, which increased enormously in 1971).

In 1971 the foreign currency surplus of the nongovernmental sector exceeded the foreign currency assets accumulated at the Bank of Israel during the year, since the Government puchased foreign currency to execute payments abroad (the foreign currency receipts of the Government and the National Institutions in 1971 were much smaller than their payments abroad). While this drew down the foreign exchange reserves, it did not have a restrictive monetary effect, as Bank of Israel credit to the Government was stepped up by an amount almost equal to the foreign currency purchases. Consequently, the sale of foreign currency to the Government did not offset the "printing of money" that took place when the Bank of Israel purchased foreign currency from the nongovernmental sector.

In other words, the nongovernmental sector increased its foreign currency surplus as a result of its overseas transactions, while the Government increased its foreign currency deficit. The net outcome was a large external infusion: firstly, because the nongovernmental sector's surplus was much larger than the Government's deficit; and secondly, because the Government deficit was not reflected by any mopping up of liquidity, since the Government increased its debt to the Bank of Israel at the same time that it purchased foreign currency.

These large infusions pose some questions concerning the coordination of foreign exchange reserves policy and fiscal policy in 1971. As regards foreign exchange reserves, the policy in 1971 was to expand them after they had been heavily depleted in 1968 and

Table XIV–3

LIQUID ASSETS OF THE BANKING INSTITUTIONS, BY SOURCE, 1969-71

(IL million)

End of period	Net foreign currency with the Bank of Israel	Bank of Israel credit to the Govt.	Net Bank of Israel credit to the public[a]	Bank of Israel open-market operations	Other transactions[b]	Total external infusions (1 to 5 incl.)	Less: Currency held by the public	Less: Net foreign currency balances of banking institutions with Bank of Israel	Less: Balances in transit	Total liquid assets of banking institutions (6-7-8+9)	Assets not requiring liquid cover
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1969	1,196.7	2,585.6	797.2	–229.6	23.7	4,326.2	1,128.9	2,345.2	16.8	868.9	449.3
1970	1,225.5	3,478.3	803.6	–321.5	22.8	5,163.1	1,280.7	2,789.9	8.4	1,100.9	536.5
1971	2,299.1	4,898.3	973.7	–476.6	23.0	7,671.5	1,584.4	4,169.3	37.6	1,955.4	635.3
1971 January	1,227.3	3,560.8	794.4	–324.6	10.0	5,247.9	1,301.5	2,843.1	–10.8	1,092.5	538.2
February	1,194.5	3,694.7	786.2	–320.8	4.6	5,349.4	1,332.5	2,887.1	11.4	1,141.2	514.2
March	1,417.2	3,482.4	868.5	–321.9	33.8	5,412.4	1,385.1	2,977.9	12.9	1,062.3	538.5
April	1,407.8	3,824.4	820.9	–343.8	30.2	5,679.1	1,422.9	3,014.0	22.9	1,265.1	488.5
May	1,303.8	4,236.7	833.5	–359.8	–10.5	6,024.7	1,426.6	3,118.9	7.1	1,486.3	484.7
June	1,352.7	4,519.5	845.1	–382.6	32.3	6,302.4	1,438.6	3,201.3	23.2	1,685.7	513.2
July	1,376.4	4,639.2	836.8	–398.8	8.0	6,445.6	1,487.6	3,241.3	8.3	1,725.0	521.6
August	1,795.2	4,857.8	965.0	–440.3	63.7	7,114.0	1,485.9	4,011.8	33.7	1,650.0	570.0
Devaluation differentials	*253.6*	*359.5*	*144.6*	–	*88.0*	*669.7*	–	*669.7*	–	*0.0*	*16.0*
September	2,169.1	4,851.7	911.1	–466.4	94.0	7,371.5	1,542.9	4,050.0	2.3	1,780.9	572.2
October	2,222.1	4,816.5	899.0	–477.8	92.9	7,366.9	1,572.1	4,021.6	17.9	1,791.1	569.7
November	2,265.3	4,836.2	915.0	–475.2	86.0	7,455.3	1,574.5	4,031.2	27.3	1,876.9	595.3
December	2,299.1	4,898.3	973.7	–476.6	23.0	7,671.5	1,584.4	4,169.3	37.6	1,955.4	635.3

[a] Credit to the public from the Bank of Israel, less deposits of the Post Office Bank and other financial institutions with the Bank of Israel.
[b] Net income of the Bank of Israel and the Bank's other accounts.

1969 and remained at a low level in 1970. At the end of 1970 the foreign currency reserves at the Bank of Israel totalled $361 million, regarded as insufficient in the light of both political and economic considerations. The buildup of reserves in 1971 was due partly to deliberate measures to increase foreign currency receipts and partly to economic developments that were not directly supervised or controlled by the economic authorities and hence may be regarded as unforeseen.[6]

Some of the policy measures adopted in 1970 and 1971 were designed to reduce the balance of payments deficit on current account and to encourage various entities in the nongovernmental sector to obtain loan and investment capital and unilateral remittances from abroad. Besides the larger volume of such receipts, there was an increase in foreign currency receipts arising from the buoyant level of economic activity and the greater immigration of recent years. The reference is to the flow of foreign currency to the real estate market, heavier investments in the different economic sectors, immigrant transfers, and apparently also some inflow of capital induced by the differential between the relatively high interest rates in Israel and the low rates in the international money markets.

This policy of replenishing the country's foreign currency balances was not accompanied by a fiscal policy aimed at countering the inflationary pressures generated by the growth of such reserves. Therefore, in the end the economy had to pay for the expansion of reserves by printing more money. Though monetary policy in 1971 was devised to siphon off some of the excess liquidity, it proved inadequate, as the measures introduced were not accompanied by a sufficiently stringent fiscal policy. The need for such a policy was felt in the postdevaluation period, especially the first quarter of 1972, as foreign currency reserves continued to mount rapidly in the face of a very sizable external infusion.

It should be added that not all of the private sector capital import leads to an increase in liquidity, since part of the personal restitution receipts, immigrant transfers, and other foreign currency flowing into the country is frozen at the Bank of Israel in the form of various foreign currency deposits created for this purpose. This applies particularly to the period before August 1971; thereafter the volume of conversions from these foreign currency deposits rose somewhat. It should also be noted that the devaluation of the Israeli pound and the revaluation of European currencies (especially the German mark) in 1971 yielded large capital gains on deposits in or linked to these currencies. These capital gains are, of course, not reflected in balance of payments data, but their conversion – even if only partial – injects additional liquidity into the economy (see the discussion in section 5 [a]).

The large-scale infusions of 1971 began in February, after the money base had remained stable during the four preceeding months.[7] The second quarter (i.e. the begin-

6. See the *National Budget for 1971*, published by the Bank of Israel Research Department and the Economic Advisory Bureau, Ministry of Finance, February 1971, p. 20: "Capital imports in 1971 are expected to be roughly the same as the deficit on current account. . . . The economy's foreign exchange reserves will therefore hold steady."

7. The data of Table XIV-3 overstate the April 1971 infusion and understate that of March because they reflect transactions carried out in the last two days of the fiscal year. During the first 29 days of March 1971 the money base rose by over IL 120 million.

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Table XIV–4

THE LIQUIDITY OF BANKING INSTITUTIONS IN ISRAELI CURRENCY, 1969-71

(IL million)

End of period	Total liquid assets of banking institutions[a]	Liquid assets held against deposits requiring special liquid cover[b]: Required liquid cover	Recognized deficiency	Actual liquid cover (2–3)	Liquid assets held against liquid deposits (1–4)	Credit within framework of liquidity exemptions	Liquid assets held against deposits requiring ordinary liquid cover (5 + 6)	Deposits requiring ordinary liquid cover[c]	Effective liquidity ratio (7 ÷ 8)	Rate of liquidity exemptions (6÷8)[d]	Effective liquidity ratio on ordinary deposits (9 – 10 = 5 ÷ 8)	Free reserves: Balance at end of month	Daily average	Ratio between free reserves and liquid assets (daily average – %)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
1969	868.9	144.0	0.0	144.0	724.9	449.3	1,174.2	1,870.0	62.8	24.0	38.8	–30.1	–	–
1970	1,100.9	347.9	62.0	285.9	815.0	536.5	1,351.5	2,130.2	63.4	25.2	38.2	–35.1	8.2	0.8
1971	1,955.4	608.9	0.0	608.9	1,346.5	635.3	1,981.8	2,796.2	70.9	22.7	48.2	105.6	133.4	7.0
1971 January	1,092.5	364.7	52.0	312.7	779.8	538.2	1,318.0	2,091.5	63.0	25.7	37.3	–47.5	–10.0	–0.9
February	1,141.5	376.4	41.7	334.7	806.8	514.2	1,321.0	2,134.6	61.9	24.1	37.8	–75.1	–37.8	–3.3
March	1,062.3	384.7	33.0	351.7	710.6	538.5	1,249.1	2,212.9	56.4	24.3	32.1	–202.2	–46.2	–3.9
April	1,265.1	387.4	20.8	366.6	898.5	488.5	1,387.0	2,260.9	61.4	21.6	39.8	–80.9	–132.9	–11.4
May	1,486.2	400.6	10.3	390.3	1,095.9	484.7	1,579.9	2,343.2	67.5	20.7	46.8	35.1	–27.4	–1.6
June	1,685.6	449.0	0.0	449.0	1,236.6	513.2	1,749.8	2,468.1	70.9	20.8	50.1	96.4	79.0	4.9
July	1,725.0	513.6	0.0	513.6	1,211.4	521.6	1,733.0	2,474.1	70.0	21.1	48.9	57.3	69.1	4.4
August	1,650.0	520.2	0.0	520.2	1,129.8	570.0	1,699.8	2,527.9	67.2	22.5	44.7	5.5	23.5	1.4
September	1,780.9	534.0	0.0	534.0	1,246.9	572.2	1,819.1	2,601.4	69.9	22.0	47.9	75.1	76.2	4.3
October	1,791.1	587.9	0.0	587.9	1,203.2	569.7	1,772.9	2,612.4	67.9	21.8	46.1	21.1	21.8	1.2
November	1,877.0	553.2	0.0	553.2	1,323.8	595.3	1,919.1	2,645.1	72.5	22.5	50.0	145.1	98.8	5.5
December	1,955.4	608.9	0.0	608.9	1,346.5	635.3	1,981.8	2,796.2	70.9	22.7	48.2	105.6	133.4	7.0

[a] Data from column 9 in Table XIV-3.

[b] Israeli currency time deposits and Israeli currency deposits requiring 90 or 100 percent liquid cover.

[c] The required liquidity ratio for ordinary deposits, which are mostly demand deposits, was 65.5 percent until May 1 and 67.5 percent from June 1 until the end of the year.

[d] In 1971 the ceiling for liquidity exemptions was 28 percent of demand deposit balances.

ning of the 1971/72 fiscal year) saw the most striking upswing in the money base, but it continued to expand rapidly in the third and fourth quarters.

In the first quarter of 1971 the banks had small liquidity deficits: disregarding the last week of March, the average weekly deficit during this period was IL 27 million. There was a relatively brisk demand for credit, and as the banking institutions met this their free reserves shrank rapidly in comparison with the end of 1970 (see Table XIV-4). The contraction of reserves was reflected not only by larger liquidity deficiencies, but also by the repayment of credit granted to the Government at the end of 1970, when the institutions possessed substantial liquidity surpluses.

The institutions' liquidity position in the first half of 1971 was greatly affected by the activities of the Accountant General in the last week of the fiscal year. Massive borrowings pushed up the overall liquidity deficit to IL 190 million by the end of the fiscal year. The appreciable liquidity infusion in April and May gradually whittled this down, and by the end of May the deficit turned into a surplus. Presumably the banking institutions' readiness to expand credit in the first quarter of 1971, despite the relative shortage of liquidity, is explained by the prevailing expectations of a large liquidity infusion in the next quarter.

From the last week of May until the end of December 1971 there was a substantial liquidity surplus in every week, except that in which the Israeli pound was devalued. This situation continued through the first quarter of 1972.

In view of the big external infusions and the increased liquidity of the economy, the Bank of Israel decided on the following restraining measures:

(1) In April it reduced its participation (by way of rediscounts) in the Export Financing Fund by 15 percent. The corresponding increase in the banking institutions' share absorbed IL 50 million of their free resources.[8]

(2) The liquidity ratios on demand deposits were raised by one percentage point on both May 13 and June 3, sterilizing IL 47 million. After these hikes the reserve requirements on such deposits reached 67.5 percent.

(3) The liquidity ratios on time deposits were raised by one percentage point on June 17, and again on July 1 and July 15, sterilizing IL 79 million. These changes brought the ratio on deposits for six months or more up to 18 percent.

(4) In the first half of 1971 there was a continued absorption of liquidity due to the extension of the liquidity regulations to bill brokerage with the abolition of the Interest Law in 1970. During this period a total of IL 62 million, or approximately IL 10 million a month, was mopped up until the recognized deficiency was liquidated.

(5) At the beginning of August the return of the Short-Term Loan was raised – by 0.75 of a percentage point on series maturing in three or six months and by half a point on other series. These changes resulted in the siphoning off of a much larger amount of liquidity through open-market operations in the year reviewed, the total figure coming to IL 155 million.

8. After this change the composition of the fund was as follows: free resources of the banking institutions – 40 percent; credit exempted from the liquidity requirements – 25 percent; and Bank of Israel rediscounts – 35 percent.

(6) The expansion of nondirected bank credit to the public was limited, and the interest rate on the institutions' liquidity surpluses held at the Bank of Israel was raised to 16 percent p.a. as part of the postdevaluation policy. From August 22 to November 4 the growth of credit was limited to 0.25 percent a week in relation to the volume outstanding on August 22. As the latter stood at IL 3,400 million, the directive limited the expansion of such credit to IL 36 million a month. The ceiling was frozen on November 4 at that day's level, and the freeze was maintained until April 1972. The data indicate a low utilization of the credit ceiling: the unutilized balance totalled IL 235 million at the end of September, IL 190 million at the end of October, IL 202 million at the end of November, and IL 200 million at the end of December.

(7) The participation of the banking institutions in the Export Financing Fund was gradually scaled up by IL 47 million between the beginning of September and the middle of October, a step that added 20 percent to their postdevaluation deposits in the fund. This can be attributed to the special structure of the fund: credit from the fund is granted in foreign currency when the exporter discounts his bills at the Bank of Israel, while the banks' participation takes the form of local currency deposits with the Bank of Israel. In order to maintain the relative shares of the three sources of funds, the central bank accordingly had to request the banking institutions to increase their deposits from their free resources by 20 percent (such deposits are not deemed to be liquid assets).

(8) The scaling up of the required liquidity ratios in place of credit limitations was begun on December 16, when the ratios for time deposits were raised by 2 percentage points; between January and March 1972 they were increased by an additional point per month, making a total rise of five points. The ratios on demand deposits were raised by a total of 4.5 percentage points beginning in February 1972. These changes resulted in the absorption of IL 55 million in December 1971 and should mop up a further IL 215 million between January and March 1972.

The change in the structure of the export funds was an important factor in checking the expansion of Bank of Israel credit to the public. This went up by IL 142 million in 1971, but devaluation increments on foreign currency credit amounted to IL 145 million. By contrast, credit granted from funds exempted from the liquidity requirements grew by an appreciable IL 99 million, of which IL 16 million can be attributed to the devaluation.[9] The liquidity infusion generated by the expansion of directed credit (connected in the main with the rapid growth of exports and their financing) was offset to some degree by the absorptive measures of the Bank of Israel. Short-Term Loan sales mopped up IL 155 million, the increased participation of the commercial banks in the Export Financing Fund accounted for IL 97 million, while the raising of liquidity ratios siphoned off IL 241 million in 1971 and an additional IL 215 million up to May 1972. The total amount absorbed was IL 254 million in 1971, compared with IL 178 million in 1970 (IL 155 million of it in the form of import deposits).

9. Along with the postdevaluation increase in the banking institutions' participation in the Export Financing Fund from their free resources, the quota of credit within the framework of the liquidity exemptions was stepped up in order to maintain the composition of the fund's resources.

The raising of the interest rate paid on liquidity surpluses to 16 percent in August 1971 also had a restrictive effect, though its results cannot be pinpointed and are not included in the above data. If a relatively high interest rate had not been set on liquidity surpluses, interest rates in the free market probably would have fallen and credit to the public would have expanded faster. Some idea of the contractionary impact of this measure can be gained from the fact that liquidity surpluses during the September-December period hit a weekly average of close to IL 80 million.

The difficulty of applying an effective monetary policy in the face of large external infusions was discussed in section 2 above. The main monetary measures introduced in 1971 were aimed at reducing the banking institutions' capacity and willingness to expand credit to the public. However, their usefulness was blunted by the creation of abundant liquidity, so that the various economic sectors did not have to borrow heavily in order to finance their operations. The big liquidity surpluses since May 1971 are evidence that the steps taken by the Bank of Israel failed to tighten the money market.

It should be noted that the increase of 1-1.5 percentage points in the debitory interest rate in the second quarter of 1971 did not reflect any tightness in the money market, since it occurred when the banks were beginning to run liquidity surpluses. The revision of the interest rate on liquidity surpluses doubtless averted an almost certain decline in free-market interest rates in the face of a fairly prolonged buildup of surpluses.

Despite the limited effectiveness of the customary restrictive monetary measures during a period of large external infusions, it should be noted that the diminution of the banking institutions' capacity to grant more credit to the public has a constrictive effect: it shores up the interest rate and keeps the institutions from stimulating the demand for credit.

4. MONEY SUPPLY

The growth of the money supply gathered momentum in 1971, the level going up by IL 956 million, or 28.2 percent, compared with 14 percent in 1970 and 2.5 percent in 1969 (see Table XIV-5).[10]

The curve began to ascend sharply after the 1971 devaluation. From September through December 1971 the money supply (seasonally adjusted) rose at an average monthly rate of 2.85 percent, as against 1.79 percent for the first eight months of the year.[11]

There was a steep rise every third month – March, June, September, and December;

10. The rise in the money supply between the end of January and the end of June 1971 totalled IL 515 million, or 15.3 percent – a rate which necessitated the submission of a report by the Governor of the Bank of Israel, in accordance with section 35 of the Bank of Israel Law. The report was presented to the Government and the Finance Committee of the Knesset on September 12, 1972.

11. Data for the first quarter of 1972 indicate a continuation of the rapid uptrend. The increases in January and February 1972 brought the level up by IL 595 million, or 15.3 percent, from the end of June 1971, and consequently the Governor of the Bank of Israel had to submit an additional report (April 16, 1972).

Table XIV–5

THE MONEY SUPPLY, MONTHLY, 1971

(IL million)

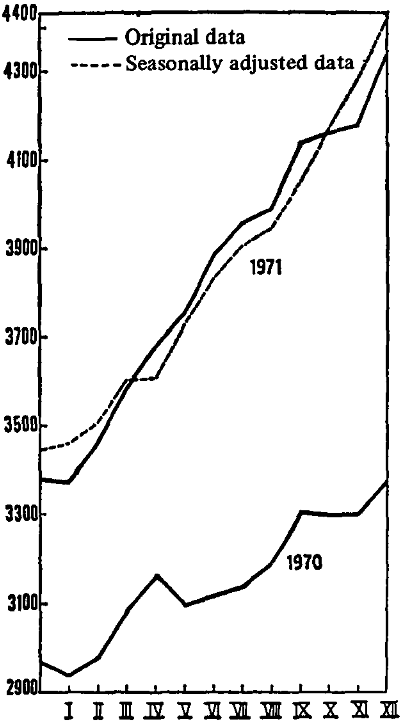
End of period	Currency[a]				Demand deposits[b]			Money supply			Money supply, seasonally adjusted[c]	
	Total	Monthly increase or decrease (–)		Percent of money supply	Total	Monthly increase or decrease (–)		Total	Monthly increase or decrease (–)		Total	Percent monthly increase or decrease (–)
		IL m.	%			IL m.	%		IL m.	%		
1970 December	1,280.7	–6.9	0.5	37.8	2,103.9	93.3	4.6	3,384.6	86.4	2.6	3,446.6	2.1
1971 January	1,301.5	20.8	1.6	38.5	2,071.7	–32.2	–1.5	3,373.2	–11.4	–0.3	3,459.6	0.4
February	1,332.5	31.0	2.1	38.5	2,127.3	55.6	2.7	3,459.8	86.6	2.6	3,505.3	1.3
March	1,385.1	52.6	3.8	38.6	2,198.9	71.6	3.4	3,584.0	124.2	3.6	3,602.0	2.8
April	1,422.9	37.8	2.7	38.7	2,253.7	54.8	2.5	3,676.6	92.6	2.6	3,608.0	0.7
May	1,426.6	3.7	0.3	38.0	2,327.0	73.3	3.3	3,753.6	77.0	2.1	3,723.8	3.2
June	1,438.6	12.0	0.8	37.0	2,449.7	122.7	5.3	3,888.3	134.7	3.6	3,834.6	3.0
July	1,487.6	49.0	3.4	37.6	2,473.3	23.6	1.0	3,960.9	72.6	1.9	3,906.2	1.9
August	1,485.9	–1.7	–0.1	37.2	2,508.2	34.9	1.4	3,994.1	33.2	0.8	3,946.7	1.0
September	1,542.9	57.0	3.8	37.3	2,593.1	84.9	3.3	4,136.0	141.9	3.6	4,058.8	2.8
October	1,572.1	29.2	1.9	37.7	2,592.5	–0.6	0.0	4,164.6	28.6	0.7	4,177.1	2.9
November	1,574.5	4.2	0.2	37.7	2,606.8	14.3	0.5	4,181.3	16.7	0.4	4,279.7	2.5
December	1,584.4	10.0	0.6	36.5	2,756.9	150.1	5.8	4,341.3	160.0	3.8	4,420.9	3.3

[a] Excluding cash held by the Israel Bank of Agriculture, Ya'ad Agricultural Development Bank, and branches of Israeli banks operating in the administered areas.

[b] Including demand deposits in branches of Israeli banks operating in the administered areas; these totalled IL 12.3 million in December 1970 and IL 7.3 million in December 1971.

[c] The adjustment for seasonal influences was made on the basis of Central Bureau of Statistics data.

Figure XIV-3
GROWTH OF THE MONEY SUPPLY, 1970-71
(IL million)



with the exception of June, the previous year witnessed a similar pattern. While part of the expansion can be attributed to seasonal factors, adjustment for seasonality does not alter the picture.

At this stage it is difficult to establish whether the monthly path traced by the money supply in 1970 and 1971 signified a change in the seasonal pattern, or whether it was the outgrowth of random factors (such as the changes in the effective exchange rate of the Israeli pound in August 1970 and in August 1971 and the strong price rise that ensued).

The proportion of currency within the money supply declined in 1971, the average monthly balance edging down from 38.8 percent in 1970 to 37.7 percent. The ratio fell in most months of the year, a development connected with the pattern of the monetary expansion. A comparison with previous years shows that this was largely a result of the heavy external infusions. Past experience has shown that a large infusion initially reduces the proportion of currency, but after a period of adjustment the latter recovers and continues to develop in accordance with the long-run trend.

5. Other Liquid Assets of the Public

This group of assets – which consists of Israeli and foreign currency time deposits, the Short-Term Loan, and approved saving schemes – increased by IL 2,389 million, or 34.9 percent, in 1971 (as against 23.2 percent in 1970). Only approved saving schemes did not share in the faster rate of expansion. The sharpest upturn was in foreign currency deposits, reflecting the growth of personal restitution payments, the devaluation of the Israeli pound, and the revaluation of the German mark. This in turn sharply increased the weight of foreign currency deposits in incremental liquid assets. Presumably the public had not yet fully adjusted its asset portfolio by the end of 1971.

Unlinked assets – time deposits and the Short-Term Loan – also expanded more rapidly during 1971, as the public had increased recourse to them for maintaining liquidity despite the sharpening inflation.

Approved saving scheme accounts, which were the slowest rising asset in this category in 1971, expanded by approximately the same amount as in 1970, so that their growth rate fell. Nevertheless, there are signs that the demand for assets linked to the consumer price index not only did not weaken in 1971 but on the contrary became stronger. This is suggested by the diminished yield on Absorption Loan and Defense Loan

Table XIV–6

OTHER LIQUID ASSETS HELD BY THE PUBLIC, 1969–71

(IL million)

End of period	Time deposits in Israeli currency[a]	Bill brokerage	IL time deposits and bill brokerage (1+2)	Saving schemes	Deposits against liabilities	Deposits linked to the exchange rate (Pazak)	Foreign currency deposits (Tamam)	Other foreign currency deposits	Total less-liquid deposits (3 to 8 incl.)	Short-Term Loan	Grand total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1969	906.0	753.8	1,659.8	1,005.4	12.9	1,618.9	611.9	171.1	5,080.0	466.7	5,546.7
1970	2,119.7	21.4	2,141.1	1,245.4	16.2	1,959.3	730.8	182.5	6,275.3	560.3	6,835.6
1971	2,858.7	0.4	2,859.1	1,482.6	16.1	2,823.9	1,166.3	159.5	8,507.5	716.8	9,224.3
1971 January	2,213.5	16.3	2,229.8	1,263.6	15.1	1,996.6	742.0	155.1	6,402.2	562.5	6,964.7
February	2,276.5	10.1	2,286.6	1,278,0	14.1	2,030.0	757.4	155.7	6,521.8	558.8	7,080.6
March	2,355.0	3.3	2,358.3	1,297.1	14.5	2,065.7	779.6	117.1	6,632.3	559.8	7,192.1
April	2,416.9	2.7	2,419.6	1,318.4	14.5	2,095.1	794.6	172.9	6,815.1	582.3	7,397.4
May	2,490.5	2.2	2,492.7	1,333.8	16.3	2,162.5	824.8	163.3	6,993.4	596.9	7,590.3
June	2,592.7	1.4	2,594.1	1,349.0	19.2	2,215.5	851.2	90.8	7,119.8	620.1	7,739.9
July	2,663.7	1.3	2,665.0	1,369.0	15.0	2,243.0	861.7	98.1	7,251.8	636.2	7,888.0
August[b]	2,707.6	0.9	2,708.5	1,391.6	18.4	2,753.3	1,053.3	152.3	8,077.4	680.8	8,758.2
September	2,730.3	0.8	2,731.1	1,409.3	17.6	2,772.7	1,096.5	171.9	8,199.1	704.3	8,903.4
October	2,773.3	0.6	2,773.9	1,428.4	17.7	2,746.2	1,109.5	183.3	8,259.0	717.4	8,976.4
November	2,813.8	0.6	2,814.4	1,450.9	18.1	2,740.6	1,122.9	130.7	8,277.6	715.6	8,993.2
December	2,858.7	0.4	2,859.1	1,482.6	16.1	2,823.9	1,166.3	159.5	8,507.5	716.8	9,224.3

[a] Excluding deposits of the public earmarked for loans, most of which belong to social insurance funds and financial institutions.

[b] Includes devaluation differentials of IL 458.7 million on Pazak deposits, IL 176.6 million on Tamam, and IL 34.3 million on other foreign currency deposits.

certificates traded in the secondary market, the increase in new issues of the Development Loan, and the higher rate of accumulation in the provident funds for the self-employed.

(a) *Pazak and Tamam accounts*

The rapid expansion of Pazak and Tamam deposits in 1971 is explained by the larger volume of personal restitution received during the year, the devaluation of the Israeli pound (which increased the IL value of the balances), and the increments arising from the European currency revaluations. These were partly offset by a slightly heavier conversion of such deposits, especially in the postdevaluation period.

Pazak accounts of restitution recipients and Tamam balances rose by IL 1,160 million, and other Pazak deposits by IL 140 million. The factors behind the swelling of these two types of foreign currency accounts will be analyzed separately.

Personal restitution receipts totalled $227 million, or IL 854 million, in 1971; devaluation increments came to IL 522 million and those arising from the European currency revaluations amounted to IL 260 million; cumulative interest on the deposits added IL 129 million more. The total potential increase in Pazak accounts of restitution reci-

Table XIV–7

ESTIMATED CONVERSION OF PAZAK AND TAMAM FUNDS BY RESTITUTION RECIPIENTS, 1971

	Restitution receipts	Interest on Pazak and Tamam accounts	Devaluation differentials	Total potential increase in Pazak & Tamam accounts (1 + 2 + 3)	Less: Actual increase	Amount convertec into IL (4 – 5)
	(1)	(2)	(3)	(4)	(5)	(6)
January	55.0	8.5	10.1	73.6	45.7	27.9
February	82.0	10.5	–3.8	88.7	36.2	52.5
March	96.0	12.0	3.5	111.5	45.6	65.9
April	81.8	7.3	–2.7	86.4	41.6	44.8
May	68.1	8.8	55.6	132.5	101.8	30.7
June	69.9	10.5	37.3	117.7	65.4	52.3
July	52.7	7.3	23.2	83.2	26.5	56.7
August	58.8	10.2	550.4	619.4	586.7	32.7
September	55.6	5.4	64.1	125.1	82.3	42.8
October	73.0	15.4	–8.6	79.8	–1.8	81.6
November	72.2	15.8	1.0	89.0	9.4	97.6
December	88.4	17.3	52.6	158.3	120.4	37.9
Total	853.5	129.0	782.7	1,765.2	1,159.8	605.4

pients and Tamam balances thus came to IL 1,765 million, while the actual increase was IL 1,160 million (see Table XIV-7).

The table reveals that conversions from Pazak (restitutions) and Tamam deposits created an external infusion of IL 604 million during 1971. A comparison of the pre- and postdevaluation data shows that conversions averaged IL 47 million a month from January through July, rising to IL 58 million a month between August and December.

The percentage of restitution receipts converted was higher during the post-devaluation period. This indicates that part of the capital gains on these deposits was realized, but the higher rate of conversions did not in itself cause a big liquidity infusion.

That the bulk of the capital gains was not converted during the postdevaluation period is not surprising, since this accords with the behavioral pattern of deposit holders after the devaluations of 1962 and 1967.[12] Various indicators show that in the period before August 1971 there were no devaluation expectations, so that deposit owners did not refrain from converting their funds for this reason. By contrast, after the devaluation they anticipated a further revaluation of the German mark (which later materialized), and this tended to discourage large-scale conversions.

It should be noted that Table XIV-7 does not reflect changes in the Natad dollar rate, which alter the value of Tamam deposits. From January to July 1971 the Natad rate slipped (signifying that the public did not anticipate an early devaluation) to an extent that resulted in capital losses of nearly IL 60 million on Tamam accounts; this wiped out half of the appreciation of such accounts due to the revaluation of the mark during the same period. In the last five months of the year the Natad dollar rate rebounded, adding IL 12 million to the Tamam balances.

The development of nonrestitution Pazak deposits shows that there was a growing tendency to convert them during the postdevaluation period. In the first seven months of 1971 these deposits expanded by IL 55 million – viz. that part of the foreign currency receipts (from exports and unilateral transfers) that was not converted into Israeli currency. But from August to December conversions amounted to about IL 31 million. In other words, in the predevaluation period there was a certain absorption of liquidity through these deposits, whereas after the devaluation their partial conversion injected liquidity into the economy. The divergent behavior of owners of these two types of Pazak deposits is explained by the fact that most of the accounts of restitution recipients are linked to the German mark, whereas most of the other Pazak accounts are linked to the U.S. dollar. Moreover, there is probably a larger element of saving in the former type of account than in the latter, which is held, at least to some extent, in order to earn devaluation increments and to immediately realize them.

(b) *Deposits in approved saving schemes*

The growth of these deposits sagged further in 1971, when the gain came to IL 237 million, or 19 percent, as against IL 240 million, or 23.8 percent, in 1970.

12. See F. Wieder, "Conversions of Personal Restitution Payments from Germany", *Bank of Israel Bulletin*, No. 33, April 1970, p. 42.

The slowdown stands out against the background of the stronger monetary expansion, the rapid accumulation in provident funds for the self-employed, and the heavier sales of newly issued index-linked bonds. The slackening in the growth of the saving schemes became more pronounced in 1971, owing largely to a shift in preferences from this type of asset to index-linked bonds and provident funds for the self-employed.[13]

This switch from saving schemes to bonds (discussed at some length in the *Annual Report* for 1970) can be attributed to the large differential between the yields on bonds purchased in the secondary market (mainly the Absorption Loans and the 1968 and 1969 Defense Loans) and the return on approved saving schemes.[14] As the public became more aware of the advantages of a direct investment in bonds, there was a distinct swing among many classes of savers from approved saving schemes to bonds.

In 1971 a number of developments affected the choice between the two types of index-linked saving. The aggravation of the inflation rendered more costly the "breaking" of a deposit in an approved saving scheme. No linkage increments are paid when such deposits are withdrawn during the first two years. Withdrawal in the third year entitles the holder to only half the linkage increment, and in the fourth year to 75 percent. Only deposits left intact for more than four years entitle the saver to full linkage. Data on the behavior of saving scheme participants reveal that a large percentage of the deposits are closed before the five-year saving period ends, and that even when the accounts are maintained for the full period, part of the sum is withdrawn before the terminal date.[15] This means that during a period of inflation those who "break" their deposits receive a much lower real yield, while owners of index-linked bonds do not incur any greater risk by selling before maturity.

The development of the relative yields also influenced savers' decisions. In 1971 yields fell both on bonds purchased in the secondary market and on saving schemes, but less so in the case of the latter. Nevertheless, the gap between the absolute yields remained fairly large, so that bonds continued to be favored. At the end of April 1971 the Treasury abolished the "conversion schemes".[16] These had yielded a higher return than the ordinary option-type saving schemes, but at the time of their abolition the differential was only 0.3 percent. The rising quotations of Absorption Loan certificates purchased for deposit in the conversion-type schemes and the eventual abolition of the schemes depressed the yield on all saving schemes by no more than one percentage point from 1970 to 1971. In contrast, the yield on Absorption and Defense Loan certificates declined to a much greater extent, but still remained higher than that on saving schemes (besides promising a capital gain with the continuation of the downtrend in yields in the secondary market until they reach those on new issues).

13. In 1971 there was a larger accumulation in the Saving-for-Housing schemes – IL 30 million as against IL 12 million in 1970 – but this is still a comparatively small figure.

14. See Bank of Israel, *Annual Report 1970*, pp. 307-10.

15. See R. Zentler, "Approved Saving Schemes, 1955-69", Bank of Israel, *Economic Review*, No. 35, November 1970, pp. 25-27.

16. Deposits in these schemes are made partly in cash and partly in Absorption Loan certificates, which are converted into cash by the Treasury.

A detailed discussion of the heavier accumulation in the provident funds for the self-employed (which are open also to wage and salary earners) can be found in Chapter XVII, section 3. The saving period in these funds is 10 years, but the effective return is much higher than for approved saving schemes, owing to the tax concessions on the former type of scheme. The extremely rapid growth of these provident funds in 1970 and 1971 proves that households are ready to considerably prolong their term of saving if they are assured a good return. This assumption is reinforced by the mounting demand for the 1968 and 1969 Defense Loans and the 1966 Absorption Loan, whose average life is longer than that of the option-type development loans and approved saving schemes.

(c) *Unlinked liquid assets*

The upward trend in unlinked "other liquid assets of the public" gathered momentum in 1971. The expansion of Short-Term Loan holdings and time deposits in Israeli currency came to IL 875 million, or 32.4 percent, as compared with IL 574 million, or 27 percent, in 1970.[17]

The vigorous growth of unlinked other liquid assets has characterized the monetary expansion since 1970, despite the precipitate advance of prices over this period. Owners of time deposits who are not tax-exempt and purchasers of the Short-Term Loan have not been earning a positive real return. The real yield on both of these assets has remained negative despite the hiking of the interest rate on time deposits by one percentage point in 1970 upon the abolition of the Interest Law and by an additional point in August 1971, and despite the raising of the nominal return on the Short-Term Loan by 0.75 of a point.

This poses the question of why holdings of these assets expanded strongly in 1970 and 1971 despite the negative real return. One reason is that it takes time for the public to adjust its behavior to the new inflationary situation. The steep advance of prices began in August 1970, and it is reasonable to assume that it did not immediately affect demand for unlinked assets.

The data on unlinked assets during the period since August 1971 show that their growth has slowed greatly, compared both with earlier periods and with the expansion of the money supply after August.[18]

A second reason lies in the role played by time deposits and the Short-Term Loan in supplying the public's liquidity requirements. In the discussion of the money supply we noted that during the last two years it expanded much more slowly than the volume of total business transactions at current prices. In 1970 and 1971 the annual average level of the money supply went up by a total of 28.6 percent, while that of resources at the disposal of the economy grew by 45.3 percent and the volume of real estate and securities transactions also soared.

17. These figures relate to the growth of time deposits net of the decrease in bill brokerage. At the end of 1970 the outstanding balance of brokered bills was IL 21 million; it continued downward during the first half of 1971 until it all but vanished.
18. This is suggested by the data for August-December 1971; provisional data for January and February 1972 point to a similar development.

Given the rise in interest rates on time deposits in 1970-71, it can be assumed that there was some shift in liquidity preferences – the weight of money holdings declined, while that of other, interest-bearing, liquid assets rose.

It should be noted that even when prices are expected to continue climbing there is a demand for unlinked liquid assets. The reference is to the desire to invest funds for short periods between the execution of various transactions, such as the sale of real estate, the receipt of severance pay, the financing of an imminent journey abroad, or the purchase of consumer durables. In such instances unlinked assets are held in place of money rather than linked assets, since there are no convenient value-linked assets for holding liquidity in the short run.

But in 1971 the possibility arose of investing money for relatively short periods in index-linked securities, and this apparently dampened the demand for unlinked assets. The reference is to the approaching redemption date of the 1967 Defense Loan, whose early series will start maturing in June 1972. Their purchase in the secondary market served as an index-linked short-term investment instrument. Presumably investors familiar with the workings of the bond market preferred to hold part of their liquidity in the form of Defense Loan certificates at the expense of time deposits and the Short-Term Loan.[19] The fact that the weight of Short-Term Loan series for periods of up to three months rose during 1971 lends support to this supposition. The weight of the 12- and 18-month series declined steadily throughout the year. In the third and fourth quarters the weight of the six-month series also fell, while that of the three-month series rose strongly. All this indicates that in 1971 the Short-Term Loan increasingly served as a means of holding liquidity in the short run and as a substitute for money balances.

In 1971 there was no change in the public's preferences as between time deposits and the Short-Term Loan. The latter accounted for 18 percent of the IL 895 million incremental holdings of these two assets. Between January and July the weight of the Short-Term Loan dropped to a low 11 percent, but since August, when the yield on both types of assets was raised, the share of the Short-Term Loan has shot up to 32 percent.

It should be noted that these two unlinked assets are not completely substitutable as far as the investor is concerned. The Short-Term Loan is purchased by those in high marginal income-tax brackets, and is not a good investment for persons exempted from the income tax or for financial institutions.

6. Sources of Monetary Expansion

The money supply and less liquid deposits of the public expanded in the year reviewed by IL 3,189 million, or 33 percent, compared with IL 1,610 million (20 percent) in 1970. Less the devaluation increments on deposits in foreign currency and those linked to the exchange rate, the increase came to IL 2,520 million, or 26.4 percent (see Table XIV-9).

19. The purchase of the first series of the 1967 Defense Loan in July 1971 promised a positive return, the size of which depended on the possibility of "bond washing". The expected nominal rate of return was almost certainly greater than that for the 12-month Short-Term Loan series.

Table XIV–8

EXTERNAL INFUSIONS AND MONETARY EXPANSION, 1969-71[a]

(IL million)

	Infusions originating in accumulation of foreign currency and expansion of credit to the Government	Other external infusions[b]	Total external infusions (1 + 2)	Increase in money supply	Increase in other liquid assets held by the public	Total monetary expansion (4 + 5)
	(1)	(2)	(3)	(4)	(5)	(6)
1969	83	422	505	72	991	1,062
1970	922	–85	837	415	1,288	1,703
1971	2,493	15	2,508	956	2,389	3,345

[a] Including devaluation differentials.
[b] Mainly Bank of Israel open-market operations and credit to the public.

The accelerated monetary expansion in 1970 and 1971 was accompanied by a drastic change in the contribution of foreign currency asset accumulation. Whereas bank credit to the public and Bank of Israel credit to the Government described an even upward sloping curb, with no sharp spurts in 1970 or 1971, the curve traced by foreign currency assets shows that this was the major factor in the stronger pace of monetary expansion. In 1969 the contraction of foreign currency assets counterbalanced the expansionary influence of the other sources, but in 1970 the downtrend was arrested, and the buildup of foreign currency reserves was the principal cause of the large 1971 external liquidity infusion.

The reasons for the heavy accumulation of foreign currency assets and the monetary implications of the expansion of Bank of Israel credit to the Government during a period of rising foreign currency balances were given in sections 2 and 3 above. The discussion here will be confined to the mechanism of monetary expansion. Table XIV-8 shows clearly that in 1971 there was a substantial decrease in the monetary multipliers. The ratio between the monetary expansion and the external infusions stemming from the accumulation of foreign currency assets and the expansion of credit to the Government was 1.34 in 1971, as against 1.84 in 1970. In other words, the infusions were much larger in 1971, but the average expansionary effect of each Israeli pound injected into the economy was less than in 1970.

The chief reasons for this are to be found in the comparatively sluggish expansion of Israeli currency credit to the public from the banking institutions' free resources and in the devaluation of the Israeli pound.

The relatively slow expansion of credit was due to two factors: first was the Bank of Israel's restrictive policy which, by raising the required liquidity ratios and the rate of

Table XIV–9

INCREASE IN LIQUID ASSETS OF THE PUBLIC, BY SOURCE AND COMPONENT, 1969–71

(IL million)

					Percent annual increase or decrease (–)			
			1971				1971	
	1969	1970	Incl. devaluation differentials	Excl. devaluation differentials	1969	1970	Incl. devaluation differentials	Excl. devaluation differentials
Sources								
Foreign currency assets								
With the Bank of Israel	–1,083.6	28.8	1,073.6	820.0	–47.5	2.4	87.6	66.9
With banking institutions	117.3	–205.5	–258.1	–198.1	–	–	–	–
Total	**–996.3**	**–176.7**	**815.5**	**621.9**	**–43.9**	**–14.4**	**77.3**	**58.9**
Credit from the Bank of Israel								
Credit to the Government[a]	1,167.2	893.7	1,421.5	1,062.0	94.4	38.9	43.8	32.7
Rediscounts and loans	371.6	41.2	141.7	–3.3	82.6	5.0	16.4	–0.4
Open-market operations	23.8	–91.9	–155.1	–155.1	–10.3	–40.0	–48.2	–48.2
Total	**1,562.2**	**843.0**	**1,408.1**	**903.6**	**108.9**	**28.6**	**37.2**	**23.8**
Credit from banking institutions								
Credit to the Government	121.7	201.3	42.8	42.8	34.0	42.0	6.3	6.3
To the public	320.4	508.5	647.0	647.0	12.4	17.5	19.0	19.0
In local currency[b]	–27.7	262.9	263.3	201.5	–11.8	127.5	56.1	43.0
In foreign currency								
Total	**414.4**	**972.7**	**953.1**	**891.3**	**13.1**	**27.1**	**20.9**	**19.6**
Other factors, net	79.7	–29.2	12.2	102.1	50.9	–10.2	1.6	40.0
Total sources	**1,090.4**	**1,609.8**	**3,188.9**	**2,518.9**	**15.7**	**20.0**	**33.0**	**26.1**
Components								
Money supply	71.6	414.5	956.7	956.7	2.5	14.0	28.2	28.2
Less-liquid deposits[b]	1,018.8	1,195.3	2,232.2	1,562.2	25.1	23.5	35.6	25.0
Total components	**1,090.4**	**1,609.8**	**3,188.9**	**2,518.9**	**15.7**	**20.0**	**33.0**	**26.1**
Short-Term Loan holdings of the public	–27.9	93.6	156.5	156.5	–5.7	20.0	27.9	27.9

[a] The change in credit and advances to the Government does not include the change in its liabilities arising out of transactions in Government securities with the public and banks (e.g. sales in the open market).

[b] Includes bill brokerage.

interest paid on liquidity surpluses, limited the possibility and the readiness to expand credit; the second factor was the growth of liquidity surpluses due to the relatively weak demand for bank credit.

Had the Bank of Israel not undertaken the steps described above, and were it not for its increased absorption of liquidity through open-market operations and the reduction of its share in the Export Financing Fund, the monetary multipliers would probably have been much larger than they actually were.

The devaluation of the Israeli pound and the revaluation of the German mark swelled Pazak and Tamam deposits (concurrently with the appreciation of the IL value of foreign currency balances and of the Government's linked debt to the Bank of Israel). But since the liquidity ratio for these deposits is 100 percent, the multiplier for the unrealized unconverted capital gains thereon is 1. It should be noted that devaluation reduces the average multiplier as long as there is no increased conversion of these deposits.

(a) *Bank credit to the public*

1. The expansion of credit

Bank credit to the public was up IL 1,052 million, or 22.2 percent, in 1971 – slightly more than the 20.7 percent increase in 1970. The banking institutions were in a highly liquid position in 1971; consequently, despite the Bank of Israel's restrictive monetary policy, the demand for credit was the main cause of its expansion.

Though credit to the public grew to about the same extent as in 1970, developments in this sphere during 1971 testify to an intensification of economic activity and aggregate demand in the economy. First of all, the big external infusions of 1971 generated abundant liquidity in many sectors of the economy and reduced their need for bank credit. This applies in particular to the construction industry – which was in a very liquid position thanks to brisker sales of real estate to nonresidents – and possibly also to business firms in other sectors which receive advances before and during the execution of Government contracts. Secondly, 1971 saw a much larger supply of investment financing, especially by the financial institutions sector – the expansion of such credit far exceeded the volume of capital spending. The greater volume of cheap medium- and long-term directed credit depressed the demand for ordinary bank credit for financing investments or for tiding firms over in the interim. The big increase in credit from earmarked deposits (see Table XIV-10) is a partial reflection of this development, as in many cases loans from financial institution and social insurance fund resources are actually granted through banking institutions.

These two developments suggest that the weak demand for credit, relative to the capacity of the banking institutions to expand it, was due not to a slackening of economic activity but to the existence of alternative, more convenient, sources of financing, which diminished the recourse to bank credit.

As an indicator of the influence of the increased liquidity in the economy on the demand for bank credit, we can use the development of the two components of the latter – directed and nondirected credit.

Nondirected Israeli currency credit from the banking institutions' own resources expanded by IL 418 million, or 15.9 percent, compared with 18.8 percent in 1970. In contrast, the growth of directed credit accelerated considerably – particularly that from the export and industrial working capital funds, as well as foreign currency credit from other sources (see Table XIV-11). This demonstrates that, owing to the abundant liquidity in the economy, borrowers were not inclined to procure the more expensive ordinary credit, preferring to resort more heavily to directed credit, on which interest ranges from 6 to 9 percent p.a. Since the second half of 1971 the effective rate of interest on nondirected credit has amounted to 18-18.5 percent p.a.,[20] which represents a positive real interest rate, even allowing for the rapid rise of prices. In this connection it should be mentioned that even during a period of strong inflation the question of whether it pays to resort to such credit should be weighed carefully. But such considerations are irrelevant as regards directed credit, since the rapid advance of prices and the opportunities of investing in the money market constitute an incentive to borrow as much directed credit as possible.

Table XIV–10

OUTSTANDING CREDIT GRANTED TO THE PUBLIC BY THE BANKING SYSTEM, BY SOURCE, 1969–71

(IL million)

End of period	From the Bank of Israel[a]	From banking institutions[b]	Total bank credit	From earmarked deposits of the public[c]	Against Govt. deposits	From earmarked Govt. deposits
1969	821.7	3,106.6	3,928.3	927.4	59.8	700.3
1970	862.9	3,878.0	4,740.9	1,424.7	95.6	870.0
1971	1,004.6	4,788.3	5,792.9	2,136.6	144.1	1,012.4
1971 January	879.6	3,971.5	4,851.1	1,302.5	109.0	895.6
February	890.1	4,032.6	4,922.7	1,413.8	116.8	903.3
March	945.9	4,294.6	5,240.5	1,599.3	135.8	869.2
April	906.0	4,159.5	5,065.5	1,648.6	133.5	912.9
May	917.3	4,131.4	5,048.7	1,696.7	129.5	930.3
June	953.1	4,179.0	5,132.4	1,741.4	129.1	987.9
July	944.3	4,223.4	5,167.7	1,779.1	126.6	993.2
August	1,084.8	4,386.4	5,471.2	1,833.8	120.6	1,001.7
September	1,024.0	4,453.8	5,477.8	1,884.3	126.8	1,013.9
October	1,011.6	4,517.8	5,529.4	1,970.5	133.3	1,014.8
November	1,014.6	4,524.0	5,538.6	1,987.3	132.6	1,025.4
December	1,004.6	4,788.3	5,792.5	2,107.5	144.1	1,012.4

[a] Including sales of securities by banking institutions to the Bank of Israel under the optional repurchase arrangement; this is credit granted to banking institutions and not to the public (see note [c] to Table XIV-13).

[b] Excluding loans to foreign borrowers; including bill brokerage (monthly data are given in Table XIV-6).

[c] Mainly credit from deposits of social insurance funds and financial institutions.

20. This is the rate charged by the big banks. In medium and small banks the rates are even higher.

The sagging demand for nondirected credit led to the creation of large liquidity surpluses from May 1971 onward. Demand did not pick up significantly in the post-devaluation period, and the banks continued to run liquidity surpluses in the first quarter of 1972.

The fact that in spite of the abundant liquidity debitory interest rates were raised by 1-1.5 percentage points in 1971 therefore requires explanation.[21]

Table XIV–11

INCREASE IN OUTSTANDING BANK CREDIT TO THE PUBLIC, BY COMPONENT, 1969–71

	IL million			Percent		
	1969	1970	1971	1969	1970	1971
Nondirected local currency credit from the banking institutions	256	415	418	12.9	18.8	15.9
Export and working capital funds[a]	257	149	422	29.8	13.2	34.2
Bank of Israel rediscounts	232	58	147	79.6	11.0	25.3
Within the framework of liquidity exemptions	–4	–28	68	–2.0	–11.2	30.6
Own resources	28	119	233	9.1	41.9	62.8
Government participation	1	0	–26	1.9	0.0	–44.3
Other credit within the framework of liquidity exemptions	61	64	30	33.6	25.6	9.6
Credit from saving scheme funds	0	–9	4	0.6	–25.8	15.4
Foreign currency credit by banking institutions other than through the export and working capital funds	–48	210	158	41.2	306.3	50.9
Other Bank of Israel rediscounts	140[b]	–17	–7	88.0	–5.5	–2.5
Total incremental credit from the banking system to the public[c]	666	812	1,025	20.0	20.3	21.4

[a] Industrial Export Fund, Imports-for-Exports Financing Fund, Fund for Financing Export Shipments, Diamond Financing Fund, and Industrial Working Capital Fund.
[b] Including IL 86 million in National Institution bills.
[c] These data differ somewhat from those appearing in Tables XIV-9 and XIV-10 as they include credit granted through the export and working capital funds from earmarked Government deposits.

An analysis of the conditions prevailing after the interest rate revision in the second quarter of 1971 suggests that this step was based on a misassessment of the intensity of credit demand. The existence of liquidity surpluses in June, July, and the first weeks of August is evidence that the interest rates were raised at a time when the excess demand was shrinking rapidly. The hiking of interest rates may have been warranted between October 1970 and March 1971, when there was some tightness in the money market. But the banking institutions did not raise interest rates during this period, when liquidity was

21. The effective interest rate on overdrafts was raised by the introduction of a "commitment fee" of 1 percent p.a. and the addition of half a percentage point to the interest rate. The discount rate was raised by 0.5-1 percentage point.

in short supply, but only when their free reserves began to swell, thereby creating big liquidity surpluses.[22]

The raising of the interest paid on liquidity surpluses, announced after the devaluation, shored up interest rates, even though the banks remained in a surplus liquidity position. It may therefore be assumed that had the Bank of Israel not acted to forestall the expansion of credit, the banking institutions would have cut interest rates in order to stimulate demand.

A further question posed by the existence of large liquidity surpluses in the post-devaluation period is why there was not more of a speculative demand for credit in anticipation of a price increase in the various markets. One possible explanation is the comparatively high interest charged on nondirected credit, which sharply reduced the profitability of speculative transactions.

Another possible reason is the fear of a recession that prevailed after the devaluation. This helps to explain the reluctance to accept short-term credit, even when it was in abundant supply. The bitter experience of the 1966-67 recession presumably dampened any enthusiasm for financing speculative deals by means of short-term bank credit.

Still another factor was the raising of credit from overseas sources by Israeli borrowers (in addition to the expansion of foreign currency credit by Israeli banking institutions). The interest rate differential between nondirected domestic credit and foreign credit was more than 10 percent per annum, and since no early devaluation was expected, there was a strong incentive to obtain foreign currency loan permits from the Treasury.

On the supply side, the reason for the lack of enthusiasm among banking institutions to step up credit in the postdevaluation months must be sought mainly in the relatively high interest paid on liquidity surpluses kept at the Bank of Israel. The rate has reached 16 percent per annum, which reduces the relative profitability of expanding credit to borrowers who are not good credit risks. Even when they have sizable liquidity surpluses, banking institutions will not lend to all and sundry, and there are many clients who cannot obtain any credit at all. But this alone cannot explain the existence of liquidity surpluses at a time of strong demand for credit, as in such a situation there is heavy pressure on prime borrowers to extend more credit to their customers and suppliers, and in the end this pressure will result in the provision of a larger volume of bank credit to such clients.

2. *The destination of credit*

Some of the developments described in the previous section are reflected in Table XIV-12. It shows a relatively slow expansion of credit to the construction, trade, and services sectors, as well as to private individuals. On the one hand, these sectors were

22. The raising of interest rates may have been held up for tactical reasons until the Bank of Israel announced its restrictive monetary measures. This delay prompted the banks to impute the raising of interest rates to the Bank of Israel's policy. See, for instance, the Annual Report of Bank Leumi le-Israel for 1971, p. 13: "In mid-1971, following the new monetary restraints imposed by the central bank and prolonged tight money conditions, we introduced a 1% p.a. commitment fee on authorized credit limits. In addition, rates paid on overdrafts were raised . . . ."

Table XIV–12

OUTSTANDING CREDIT[a] GRANTED TO THE PUBLIC BY THE BANKING SYSTEM, BY DESTINATION, 1969–71

(End of period)

Destination	1969	1970	1971
		IL million	
Local authorities	437.3	481.0	788.6
Public services	89.4	153.0	407.6
Credit and financial institutions[b]	342.6	521.9	757.8
National Institutions	177.1	157.8	172.1
Agriculture	415.7	515.5	599.9
Industry	1,814.9	2,294.8	2,912.7
Construction	460.8	466.3	540.5
Trade	453.0	500.4	629.9
Services	344.3	490.8	618.6
Individuals	359.4	527.5	537.1
Miscellaneous[c]	198.0	211.0	81.4
Total	**5,082.5**	**6,320.1**	**8,046.0**
		Percent	
Local authorities	8.6	7.6	9.8
Public services	1.7	2.4	5.1
Credit and financial institutions	6.7	8.3	9.4
National Institutions	3.5	2.5	2.1
Agriculture	8.2	8.1	7.5
Industry	35.6	36.3	36.2
Construction	9.1	7.4	6.7
Trade	8.9	7.9	7.8
Services	6.8	7.8	7.7
Individuals	7.0	8.3	6.7
Miscellaneous	3.9	3.4	1.0
Total	**100.0**	**100.0**	**100.0**

NOTE: The sectoral classification of part of the data for 1971 is not identical with that in previous years. Since it was impossible to reclassify the data for previous years, they are not strictly comparable with those for 1971.

[a] Bank credit, credit from earmarked deposits of the public, from Government deposits in export and working capital funds, from special Government deposits, and bill-brokerage credit; excluding credit from earmarked development budget deposits of the Government.

[b] Excluding interbank loans, loans between cooperative credit societies, and credit from the Bank of Israel to banking institutions under the optional securities repurchase arrangement.

[c] Other sectors, including credit to artisans.

affected by the large liquidity infusions, which reduced their need for credit; on the other hand, they are not eligible for soft directed credit.[23] The amount of financing supplied to industry and agriculture rose in 1971 by some IL 700 million, after expanding by IL 580 million in the previous year (this figure includes the incremental credit granted from earmarked deposits of the public). The magnitude of the incremental credit extended to these two sectors indicates that most of the growth was in directed credit, while the increase in other credit was slow.

The sharpest rises were recorded by local authorities, public service institutions, and credit and financial institutions. A large percentage of the IL 810 million additional credit to these destinations was granted from earmarked deposits, but there was also a substantial amount of bank credit.

(b) *Credit to the Government*

In 1971 the Government borrowed IL 1,422 million from the Bank of Israel, compared with IL 894 million in the previous year, while its debt to the banking institutions grew by IL 43 million, as opposed to IL 201 million in 1970 (see Table XIV-13).

These figures, however, do not fully measure the effect of the Government's deficit budget on the economy's liquidity and on the balance of payments, since account must also be taken of that part of the Government's expenditure that was financed by way of capital imports from abroad (the inflationary impact of the financing provided to the Government by the banking system is discussed in Chapter VII).

This section will deal primarily with the changes in banking institution credit to the Government, as that supplied by the Bank of Israel was discussed in section 3 above.

Banking institution credit to the Government in 1971 consisted of IL 107 million in net purchases of Government bonds, which was partly offset by a IL 52 million decrease in current credit and a IL 12 million rise in Government deposits.

As may be seen from Table XIV-13, the decline in current credit occurred in January 1971, when the Government repaid IL 97 million of its debts to banking institutions, while in most other months of the year the institutions put additional credit at the Government's disposal. The January decline resulted from the repayment of loans received by the Government in the second half of 1970 – in the main after August 1970, when the banking institutions possessed substantial liquidity surpluses. In August, September, and December 1970 the Accountant General carried out a sort of open-market operation, borrowing the liquidity surpluses of the banking institutions. These amounts were largely repaid in January 1971, when a shortage of liquidity began to manifest itself.

Most of the purchases of Government bonds in 1971 were of the Defense Loan issue floated specifically for banks; these totalled IL 101 million, of which IL 55 million represented the investment of approved saving scheme funds, while the balance was bought from the banks' own resources. It should be mentioned that the fact that sales of this

23. The jump in the amount of credit supplied to the trade and construction sectors, as recorded in the table, was probably due partly to the reclassification of the credit destinations, i.e. part of the credit under this heading was formerly included in "miscellaneous".

Table XIV–13

CHANGES IN OUTSTANDING CREDIT FROM THE BANKING SYSTEM TO THE GOVERNMENT AND NATIONAL INSTITUTIONS, 1969–71

(IL million)

End of period	From the Bank of Israel: Credit granted[a]	From the Bank of Israel: Less: Increase or decrease (–) in Govt. and National Institution deposits	From the Bank of Israel: Total	From banking institutions: Credit granted[b]	From banking institutions: Investment in Govt. securities[c]	From banking institutions: Less: Increase or decrease (–) in Govt. deposits	From banking institutions: Total	Total change in credit from the banking system (3+7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1969	1,186.4	19.2	1,167.2	47.6	84.2	10.1	121.7	1,288.9
1970	1,039.9	146.2	893.7	124.8	95.8	19.3	201.3	1,095.0
1971	1,439.1	17.6	1,421.5	–52.0	106.6	11.8	42.8	1,464.3
1971 January	109.9	26.9	83.0	–97.1	–5.8	–9.4	–93.5	–10.5
February	121.1	–12.7	133.8	2.1	23.1	5.1	20.1	153.9
March	–230.9	–18.3	–212.6	13.8	1.4	–8.9	24.1	–188.5
April	333.4	–9.1	342.5	7.1	–5.7	–3.9	5.3	347.8
May	408.8	3.5	412.3	4.2	18.4	–0.3	22.9	435.2
June	295.5	12.4	283.1	3.2	10.3	5.7	7.8	290.9
July	107.7	–12.2	119.9	0.0	–24.8	–1.7	–23.1	96.8
August	224.7	4.8	219.9	–22.7	2.6	1.6	–21.7	198.2
September	–17.4	–10.3	–7.1	0.0	9.9	1.2	8.7	1.6
October	–17.4	17.4	–34.8	–0.4	49.8	0.1	49.3	14.5
November	28.0	8.3	19.7	1.7	20.9	2.5	20.1	39.8
December	75.7	13.9	61.8	36.1	6.5	19.8	22.8	84.6

[a] Excluding Bank of Israel open-market operations in Government securities, sales of treasury bills to banking institutions, and Bank of Israel purchases of securities from banking institutions under the optional repurchase arrangement; these transactions are not accompanied by a flow of funds between the Bank of Israel and the Government, but between the Bank of Israel and the public and banking institutions.

[b] In Israeli currency only. Including banking institution deposits with the Treasury in connection with approved saving schemes of the type involving the deposit of Absorption Loan certificates; these deposits totalled IL 141.3 million at the end of 1971 and IL 121.1 million at the end of 1970.

[c] Excluding changes in holdings of treasury bills and the Short-Term Loan (for reasons that are explained in note [a] to this table). Government securities sold to the Bank of Israel under the optional repurchase arrangement have also been excluded; the outstanding balance of such securities totalled IL 24.7 million at the end of 1971 and Il 28.1 million at the end of 1970 (see note [a] to Table XIV-10).

issue began in May 1971 – when the banking institutions had liquidity surpluses – blunted the absorptive impact of this measure.

Purchases of Development Loan certificates with saving scheme funds totalled IL 66 million. It will therefore be seen that in 1971 banking institutions unloaded part of their portfolio of Government bonds, for purchases with saving scheme funds plus purchases of the bank Defense Loan issue came to IL 167 million, while the institutions' holdings of Government securities grew by only IL 107 million.

Quarterly data show that there was a IL 71 million net sale of Government bonds from the banks' portfolio in the third quarter and IL 15 million worth in the second quarter, while in the fourth quarter there was a net purchase of IL 24 million worth of bonds, and IL 2 million worth in the first quarter. Most of the net sales in the second and third quarters can probably be ascribed to the anticipation of a growing demand for credit and the desire to build up funds to meet this demand; the existence of such expectations was reflected in the raising of the debitory interest rate. The remaining portfolio sales were apparently of the 1968 bank Defense Loan issue. When this IL 100 million loan was floated, the banks undertook not to sell their holdings for a period of three years. Some of the institutions probably took advantage of the expiration of this time limit to reshuffle their asset portfolio, and unloaded part of their holdings in 1971.

(c) *Foreign currency assets*

In 1971 net foreign currency assets held by the Bank of Israel grew by $197 million, or IL 820 million (not counting their appreciation due to the devaluation of the Israeli pound); this compares with a rise of $8 million (IL 19 million) in 1970 (see Table XIV-14). The 1971 increase resulted from the expansion of capital imports and the cutting of the import surplus (discussed in section 2 above).

The accumulation of foreign currency assets added $215 million to the reserves held at the Bank of Israel, after they had expanded by $25 million in 1970 and contracted sharply in both 1969 and 1968.[24] Of the 1971 increment, $35 million represents the appreciation of assets held in German marks due to the revaluation of this currency. The allocation of Special Drawing Rights by the International Monetary Fund augmented the reserves by $14 million, while $10 million was drawn on Israel's first credit tranche in the IMF.

In 1971 the banks greatly stepped up their foreign currency transactions, raising a total of $421 million abroad during the year – mainly in the form of loans and deposits from foreign banks and nonresidents. Of this sum, $86 million was deposited in the Bank of Israel to provide liquid backing against these liabilities, while $335 million remained at the disposal of the institutions for granting various types of credit.[25] Most of the foreign

24. Foreign currency balances held at the Bank of Israel consist of gold, Special Drawing Rights, deposits and other liquid investments of the Bank, less deposits of foreign banks with the Bank of Israel and that part of the Patach deposits that is redeposited with the Bank.

25. The data in this section are presented in U.S. dollars, as the changes in IL terms reflect not only the increase in the volume of transactions but also the effect of the devaluation of the Israeli pound.

Table XIV–14

FOREIGN CURRENCY ASSETS AND LIABILITIES OF THE BANKING SYSTEM, 1969-71

(IL million)

End of period	Bank of Israel				Banking institutions			
	Foreign currency assets	Foreign currency liabilities		Net assets (1–2–3)	Foreign currency assets[c]	Foreign currency liabilities		Net assets (5–6–7)
		Patach deposits[a]	Other liabilities[b]			Patach deposits[d]	Other liabilities[e]	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1969	1,627.6	152.9	278.0	1,196.7	1,114.6	675.1	404.3	35.2
1970	1,791.0	209.8	355.7	1,225.5	1,799.8	1,036.5	933.6	–170.3
1971	3,355.2	613.9	442.2	2,299.1	3,343.0	1,991.7	1,779.7	–428.4
1971 January	1,888.0	227.6	433.1	1,227.3	1,958.7	1,136.5	1,036.6	–214.4
February	1,991.4	282.0	514.8	1,194.6	2,099.4	1,191.6	1,101.9	–194.1
March	2,219.7	313.6	488.8	1,417.3	2,029.7	1,241.7	1,241.3	–333.3
April	2,256.2	374.0	474.4	1,407.8	2,010.3	1,149.6	1,073.7	–213.0
May	2,186.9	406.2	476.9	1,303.8	1,919.6	1,169.6	987.9	–237.9
June	2,166.1	399.0	414.4	1,352.7	2,000.7	1,319.3	999.0	–317.6
July	2,300.7	428.5	495.8	1,376.4	2,279.8	1,426.6	1,165.8	–291.8
August	2,976.0	534.7	646.1	1,795.2	3,474.7	1,831.5	1,954.7	–311.5
September	3,289.6	522.6	597.9	2,169.1	3,635.4	1,858.7	2,097.8	–321.1
October	3,358.3	455.8	591.1	2,222.4	3,678.6	1,857.9	2,142.0	–321.3
November	3,341.6	565.1	511.2	2,265.3	3,387.8	1,904.4	1,883.0	–399.6
December	3,355.2	613.9	442.2	2,299.1	3,343.0	1,991.7	1,779.7	–428.4

[a] Nonresidents' deposits redeposited by the banking institutions with the Bank of Israel.
[b] Including deposits with foreign banks and Israeli currency deposits to the credit of the International Monetary Fund in connection with drawings on the gold tranche and the first credit tranche. In 1970 and 1971 also includes the IMF allocation of Special Drawing Rights to the Bank of Israel.
[c] Mainly deposits with foreign banks and loans to nonresidents.
[d] Nonresidents' deposits, less sums redeposited with the Bank of Israel.
[e] Mainly deposits and loans from foreign banks, less net foreign currency loans to the Government.

currency credit went to foreign banks, which received some $250 million. The large volume of business conducted with foreign banks – the procurement of funds from banks abroad and the granting of loans therefrom to other foreign banks – reflects the growth of arbitrage transactions by Israeli banks in the international capital markets.

In addition, credit to nonresidents and foreign investments expanded by about $30 million, and foreign currency credit to Israeli residents by $48 million. The latter type of credit, which is given on the strength of special permits issued by the Treasury and the Bank of Israel, is intended for two main purposes. The first is connected with the banks' participation in the export funds. The reference is to the diamond fund, in which the banks' share was increased by $3 million in 1971, and to the fund for financing imports-for-exports, where the increase came to $15 million; in both cases the changes were due chiefly to the expansion of the funds. The second purpose is related to the financing of imports and to domestic uses; this type of foreign currency credit grew by $30 million in 1971.

From the aspect of monetary developments, the expansion of foreign currency credit to Israeli residents is of interest; while the other types of foreign currency transactions listed above affect the liquidity of the Israeli economy and its foreign exchange reserves, they do not affect the domestic money market.[26]

In 1971 the amount of foreign currency credit granted to Israelis other than through the export funds expanded by $30 million, compared with $60 million in 1970, whereas the banks' participation in the two aforementioned funds increased by $18 million in 1971, as against $14 million the year before.

Most of the growth in foreign currency credit from sources outside the export funds occurred in the postdevaluation period; this is explained by the big interest rate differential between the international and the Israeli money market and by the fact that foreign currency credit recipients did not run any risk of losses due to a devaluation.

7. The Development of Banking Institutions

The combined balance sheet of the banking institutions for 1971 reflects the rapid monetary expansion during the year and the devaluation of the Israeli pound, which increased the IL value of foreign currency assets and liabilities and those linked to foreign currencies. The balance sheet grew by IL 8,700 million, or 51.1 percent, compared with 31.3 percent in 1970 (see Table XIV-15).

The strong monetary expansion was mirrored by a big rise in demand deposits and less liquid deposits of the public, with part of the growth in the latter representing devaluation increments on Pazak, Tamam, and other deposits linked to the exchange rate.

The balance sheet also reflects the expansion of the banks' foreign currency transactions, a trend begun in 1970. The amount of funds mobilized overseas was up $421 million, after growing by $271 million in 1970. As already explained in section 6 above, most of this sum was invested abroad, the balance being deposited in the Bank of Israel for granting credit to various Israeli companies and institutions.

26. See the discussion in Chapter III, "The Balance of Payments", section 5 (d).

Loans from earmarked deposits of the public – mainly those of financial institutions and social insurance funds – also expanded strongly in 1971.

During the year one bank floated a IL 10.5 million share issue and a IL 25 million issue of capital notes. The balance sheet figure on capital notes reflects this issue, as well as devaluation increments on capital notes denominated in foreign currency and an offsetting conversion of such paper into shares to the tune of IL 15 million.

Table XIV–15

ASSETS AND LIABILITIES OF BANKING INSTITUTIONS, 1970–71

	IL million		Percent		Increase or decrease (–)	
End of period	1970	1971	1970	1971	IL m.	%
Assets						
Cash, balances with the Bank of Israel, and treasury bills	4,093.1	6,690.6	26.4	28.4	2,597.5	63.5
Loans to the public[a]	3,983.3	6,020.2	25.7	25.5	2,036.9	51.1
Loans to the Government	214.2	162.2	1.4	0.6	–52.0	–24.3
Loans from earmarked deposits	3,235.5	4,479.5	20.8	19.0	1,244.0	38.5
Of the Government	965.4	1,156.6	6.2	4.9	191.2	19.8
Of the public[b]	1,789.7	2,843.7	11.5	12.1	1,054.0	59.9
Of foreign banks and companies	480.4	479.2	3.1	2.0	–1.2	–0.3
Foreign currency assets	1,799.8	3,343.0	11.6	14.2	1,543.2	85.7
Securities	1,274.4	1,524.8	8.2	6.5	520.4	19.7
Real estate	160.6	204.6	1.0	0.9	41.0	27.4
Net balances with other banking institutions	–67.6	–122.7	–0.4	–0.5	–55.2	–81.7
Other accounts	814.2	1,256.4	5.3	5.4	442.2	54.3
Total	**15,507.6**	**23,558.5**	**100.0**	**100.0**	**8,050.9**	**51.9**
Liabilities						
Demand deposits in Israeli currency	2,085.1	2,731.2	13.4	11.6	646.1	31.0
Less liquid deposits[c]	6,380.7	9,739.4	41.1	41.3	3,358.7	52.6
Liabilities to foreign banks[d]	2,179.9	4,385.3	14.1	18.6	2,205.4	101.2
Earmarked Government deposits	1,009.6	1,212.5	6.5	5.2	202.9	20.1
Earmarked deposits of the public	1,821.3	2,909.3	11.7	12.4	1,088.0	59.7
Earmarked deposits of foreign banks and companies	480.4	479.2	3.1	2.0	–1.2	–0.3
Equity capital	419.2	478.4	2.7	2.0	59.2	14.1
Capital notes	42.5	54.2	0.3	0.2	11.7	27.5
Other accounts	1,088.9	1,569.0	7.1	6.7	480.1	44.1
Total	**15,507.6**	**23,558.5**	**100.0**	**100.0**	**8,050.9**	**51.9**

Table XIV–15 (contd)

ASSETS AND LIABILITIES OF BANKING INSTITUTIONS, 1970–71

	IL million		Percent		Increase or decrease (–)	
End of period	1970	1971	1970	1971	IL m.	%
Contingent accounts						
Balances held by and for banking institutions	188.8	266.7			77.9	41.3
Clients' liabilities and guarantees for clients	1,345.8	1,917.3			571.5	42.5
Total	**1,534.6**	**2,184.0**			**649.4**	**43.3**
Grand total	**17,042.2**	**25.742.5**			**8,700.3**	**51.1**

[a] Excluding bill brokerage. The figures for 1970 and 1971 are respectively IL 126.7 million and IL 1,232.3 million larger than those shown in Table XIV-10, since they include Bank of Israel loans to banking institutions in these amounts.

[b] Mainly deposits of financial institutions and social insurance funds. The figures for 1970 and 1971 are respectively IL 440.2 million and IL 707.0 million larger than those listed in Table XIV-10, since they include loans to the Government.

[c] Excluding bill brokerage; including Bank of Israel loans and rediscounts (see note [a]).

[d] The figures for 1970 and 1971 are respectively IL 209.8 million and IL 613.9 million larger than those shown in Table XIV-14, since they include nonresidents' deposits redeposited with the Bank of Israel.

The number of banking institutions was reduced by two during the year. The Israel Loan and Savings Bank (Formerly Tel Aviv-Jaffa Ltd.) transferred its business to Bank Hapoalim, while the Ya'ad Agricultural Development Bank changed its status from a commercial bank to that of a financial institution.

At the end of 1971 Barclays Bank International Ltd. transferred its branches to a new bank, the Barclays Discount Bank Ltd., which is a partnership between the former concern and the Israel Discount Bank.

The number of bank branches rose by 19 in 1971, and the number of branch offices of cooperative credit societies by two. One of the new bank branches was opened in Sharm el-Sheikh.

Table XIV-16 shows a continuation of the trend toward the centralization of banking business. The weight of the three big banks increased further in the volume of credit granted, deposits, and the number of branches. The weight of credit cooperatives declined somewhat, as did that of the smaller banking concerns.

8. Operating Results of the Banking Institutions

The strong expansion of the banking institutions in 1971 was, of course, accompanied by an accelerated growth of income and profits (see Table XIV-17).

The 66.9 percent jump in income from interest on loans is attributable primarily to the much larger volume of credit granted to the public from the banking institutions' own

Table XIV–16

SELECTED INDICATORS OF THE CONCENTRATION OF BANKING BUSINESS, 1969-71[a]

(percentages)

End of period	The Big Three	Other banks	Credit co-operatives	Total
Cash and balances with the Bank of Israel				
1969	80.0	18.6	1.4	100.0
1970	79.0	19.7	1.3	100.0
1971	78.8	20.0	1.2	100.0
Loans to the public[b]				
1969	65.7	32.0	2.3	100.0
1970	72.2	25.4	2.4	100.0
1971	74.1	24.2	1.7	100.0
Demand deposits in Israeli currency				
1969	69.5	26.1	4.4	100.0
1970	69.5	26.6	3.9	100.0
1971	73.1	23.2	3.7	100.0
Other deposits[c]				
1969	81.2	17.7	1.1	100.0
1970	80.4	18.2	1.4	100.0
1971	81.8	16.9	1.3	100.0
Number of head offices and branches				
1969	56.1	35.5	8.4	100.0
1970	56.7	34.8	8.5	100.0
1971	62.2	29.3	8.5	100.0

[a] The data do not include the Ya'ad Agricultural Development Bank and the Israel Bank of Agriculture.
[b] Including credit to nonresidents; in 1970 including sums transferred from the bill brokerage market.
[c] Including deposits of nonresidents (Patach).

resources and from earmarked deposits. It also reflects the fact that a large percentage of the credit business in 1970 was transacted in the form of bill brokerage (this market began to disappear only in April 1970); for this reason the raising of interest rates in 1970 did not find full expression in the banks' income for that year.

The switching of funds from bill brokerage to ordinary time deposits reduced the banks' income from service charges, and this explains the relatively sluggish growth of this item in 1971.

Table XIV–17

OPERATING RESULTS OF BANKING INSTITUTIONS,[a] 1970-71

	IL million		Percent		Percent annual increase or decrease (–)	
	1970	1971	1970	1971	1970	1971
Operating income						
Interest on loans	697.3	1,163.9	55.0	55.5	86.0	66.9
Service charges	156.4	179.0	12.3	8.5	–4.8	14.4
Interest on deposits with the Bank of Israel and other banks	247.8	443.7	19.6	2.1	32.7	79.1
Other income[b]	166.3	311.8	13.1	14.9	46.6	87.5
Total	**1,267.8**	**2,098.4**	**100.0**	**100.0**	**51.1**	**65.5**
Operating expenses						
Payroll	233.2	294.9	19.7	15.0	17.7	26.5
Interest on deposits[c]	837.7	1,524.5	70.7	77.5	76.5	82.0
Other expenses[d]	113.2	146.6	9.6	7.5	23.7	29.5
Total	**1,184.1**	**1,966.0**	**100.0**	**100.0**	**55.0**	**66.0**
Profits						
Operating profits	83.7	132.4	99.4	86.6	11.3	58.2
Other profits (net)	0.5	20.5	0.6	13.4	–	–
Total	**84.2**	**152.9**	**100.0**	**100.0**	**5.6**	**72.7**

	1965	1966	1967	1968	1969	1970	1971
Operating profit as a percentage of operating income	9.6	5.7	7.4	8.4	9.0	6.6	6.3
Operating profit as a percentage of equity capital[e]	13.3	8.6	11.7	17.3	21.7	21.8	31.1
Totál profit as a percentage of equity capital[e]	16.2	8.5	14.3	17.8	23.1	22.0	35.9

[a] Excluding the three banks that ran into financial difficulties at the beginning of 1967 and since then are in the process of liquidation. Data for 1970 and 1971 are provisional.

[b] Including income from securities (other than capital gains) and from foreign currency, trustee, and insurance transactions.

[c] Including interest and commissions on loans received and rediscounts, as well as fines for liquidity deficits.

[d] Including administrative overheads, depreciation, donations, and bad debts.

[e] The calculation excludes foreign banks, as they do not have equity capital in Israel.

Another item that rose steeply is "other income", which includes the banks' earnings from securities (the main component) and from foreign currency transactions, trustee services, etc.

The larger 1971 income from securities reflects the upsurge of quotations during the year and an increase in linkage increments due to the rapid advance of prices in the economy.

The much higher income earned in 1971 was accompanied by a 66 percent increase in operating expenses. There was an especially fast rise in interest outlay on the various types of deposits.

Operating profits soared 86.6 percent to stand at IL 132 million. Other profits were also appreciably higher, an outcome of the surging economy and the devaluation increments earned in 1971.

The profitability measures listed in Table XIV-17 show that during the year profits rose substantially in relation to equity capital. This stemmed from a sharply higher increase in the volume of assets and income in comparison with 1970; on the other hand, the profit margin (operating profit/income) slipped a notch.