

CHAPTER XVI

MAIN MONEY AND CAPITAL MARKET DEVELOPMENTS

Monetary developments in 1975 were dominated by the huge liquidity injection on the one hand, and its absorption via the balance of payments--because of both the structural deficit and devaluation expectations--on the other. The quantity of money did not increase as fast as inflation, and so real money balances contracted, as in the previous year.

The amount pumped into the economy by the public sector--which reflects the excess of domestic payments over domestic receipts--came to IL5.5 billion, while the Bank of Israel was responsible for another IL1.5 billion, mainly through the directed credit funds. The significance of this massive inflow is demonstrated by the fact that the narrow money base (i.e. total liquid assets of the banks plus currency in circulation) came to IL6.9 billion at the beginning of 1975, equal to the entire amount put into the economy during the year. Such an enormous injection relative to the money base could have led to a staggering monetary expansion. But the measured growth of the money base turned out to be fairly mild (approximately IL500 million), because of the huge amount siphoned off via the balance of payments: the payments deficit of the private sector, whose monetary implication is the purchase of foreign currency by the sector with Israeli pounds, resulted in the drawing out of IL6.5 billion.

In contrast to 1970-73, when the private sector's capital import exceeded its current deficit (i.e. the excess of imports over exports of commodities and services), in the last two years the picture was reversed, the capital inflow limping behind the growth of the current deficit. In consequence, the sector became a net buyer of foreign currency from the Bank of Israel instead of a net seller.

As mentioned, the sector's balance of payments deficit is partly structural in nature,

the outcome of developments in the home and world economies (with respect to incomes, relative prices, terms of trade, immigrant transfers, etc.); but to some extent it apparently also reflects the propensity of business firms and households to enlarge their holdings of foreign currency assets, monetary and nonmonetary alike, in anticipation of a real devaluation (i.e. greater than the rate of inflation). Such a situation has a very strong bearing on monetary developments, as will be explained below.

Bank credit to the public, in both Israeli and foreign currency,¹ expanded at a 53 percent annual average rate in the year surveyed. This far eclipsed the 39 percent growth of resource uses at current prices, so that the weight of such credit relative to total uses rose. Long- and medium-term credit supplied by the financial institutions, mostly for investment purposes, reveal a similar picture: a rise of 44 percent as opposed to one of 36 percent in nominal domestic capital formation. What is more, the very availability of such financing, which carries a low rate of interest and a hefty subsidy element, was one of the factors stimulating capital spending despite the existence of plenty of spare capacity and the economic slowdown this year.

The much heavier volume of bank credit granted to the public in 1975 was not accompanied by a corresponding growth of liquid assets, with the result that the banking institutions incurred huge liquidity deficiencies. From the aspect of its contribution to the monetary expansion, an increase in such liquid asset shortfalls is equal to that of a liquidity injection; on the other hand, the expansion of credit at the expense of falling into a liquidity deficiency position makes such transactions costlier to the banks because of the penalties involved; this in turn engenders upward pressure on the interest rate. In this sense the liquidity deficiencies and the penalties paid may be regarded as a sort of rediscount, performed on the sole initiative and discretion of the banks, at rates higher than those normally charged.

The interest on credit granted from the banks' own means was hiked several times this year, for a total of more than 5 percentage points. In the latter part of the year the rate on overdraft facilities came to 30 percent or more, while for sums lent in excess of the authorized limits (i.e. marginal credit) it came to about 40 percent even for sound borrowers. The jacking up of the interest rate was due not only to the increased cost to

1. The foreign currency credit has been revalued according to the rates of exchange prevailing during the year. This method was adopted because total resource use, with which credit is compared, has also been measured in current price terms. Admittedly it would have been preferable to revalue the credit balance in a more refined manner, so that the credit flow would have corresponded, from the aspect of its distribution over time, to the export flow. Despite this drawback, it is better to estimate the credit balance according to the method used here than to evaluate it in dollar terms.

the banks of such transactions, but to demand factors as well: the policy of implementing frequent mini-devaluations by a total of 25 percent or more during the year (from June 1975 to May 1976 the IL was slashed by a total of 30 percent) brought up the effective rate of interest paid on foreign currency credit to 30-35 percent. It may be assumed that recipients of foreign currency credit (or that linked to the exchange rate) would be ready to convert it into IL credit if the interest did not exceed this rate. Thus the creeping devaluation and the expectation of a real change in the external value of the IL (i.e. by more than the rate of inflation) in effect set a floor on the interest charged on nondirected credit. Accordingly the present level of the interest rate should not be taken as indicative of a squeeze on money in the conventional sense of the term, and it may be expected to become a permanent feature of the local scene, at least as long as the creeping devaluation continues at its present pace. Furthermore, the upswing in interest rates can be regarded as a positive change, in that it averts the rapid running down of the country's foreign exchange reserves by making it less profitable to borrow for speculating in foreign currency.

On an annual average, the money supply was 31 percent up on 1974, which implies a drop in its real level, for the second consecutive year. This development, another manifestation of which was an increase in the circulation velocity of money, can be attributed to the public's economic behavior, reflecting the adjustment of its assets portfolio to the anticipated rate of inflation and to the return on foreign currency asset holdings; it should not be regarded as the outcome of exogenous contractionary monetary measures.

The picture that thus emerges from both the liquidity injection and credit data is that, despite the upswing in interest rates, the economy experienced a monetary growth capable of stoking a strong expansion of real activity. However, it turned out that domestic demand did not increase; for the first time since the 1966-67 slump, the economy failed to forge ahead this year, and the monetary expansion enabled the private sector to purchase more foreign currency than required for currency economic activity. It also permitted the passing on of the extra costs induced by the policy measures and the rise in wage outlay, without increasing unemployment.

As already mentioned, the liquidity injection this year (in fact since the Yom Kippur War) was daunting in comparison with the money base. This poses the question to what extent the Bank of Israel, as the central monetary authority, was duty bound to take energetic measures to counter it, either fully or partially.

The large amount of money pumped into the economy by the public sector is explained by

its huge demand surplus and credit outflow (between 1972 and 1974 the demand surplus almost tripled in real terms, at which level it plateaued in 1975--see Chapter X). The size of this demand surplus is one of the underlying causes of the country's balance of payments problem, and its reduction is a precondition for any significant pruning (and at the required pace) of the current deficit. Monetary policy should not be expected (nor would it even be desirable) to shoulder the brunt of the burden of blunting the injection built in the public sector's demand surplus.

The sector's liquidity injection is, as stated, chiefly a reflection of its demand surplus. Hence if the government put less money into the economy, this would lead both to a smaller purchase of foreign currency by the private sector and to the direct deflation of real demands in the economy--a desirable development from the aspect of both the balance of payments and the restructuring of the economy. It is against this backdrop that the Bank of Israel's policy in 1975 should be judged. As already explained, the task of absorbing liquidity ought not to fall primarily on it; but presumably a more effective policy in making the banks comply with the liquidity regulations and thereby avert the creation of such large liquidity shortfalls--which would retard the expansion of credit--would have worked in the same positive direction as public sector action to dampen the injection, namely the contraction of real activity and foreign currency purchases. Furthermore, since export industries are in any case assured preferred sources of finance, those that would prove most vulnerable to the credit squeeze are industries producing for the home market--a situation that accords with the economic policy objectives.

The very aggravation of the balance of payments problem--the most striking manifestation of which until the November 1974 devaluation was the rapid dwindling of the economy's foreign exchange reserves and the piling up of short-term foreign currency debts--made the public increasingly aware of the problem and intensified its expectation of a large real devaluation. The existence of such expectations is borne out by the fact that, despite the policy of creeping devaluation carried out since June 1975 and the 10 percent devaluation in September, the gap between the free-market and Natad dollar rates on the one hand and the official rate on the other widened steadily in the second half of the year and the prices of securities linked to the exchange rate rose precipitously.

This induced the public to reshuffle its assets portfolio, in favor of items linked to foreign currency. No data are available for directly measuring the extent of this process, but there are several indicators of the direction it took: (a) the soaring of the prices of securities linked to or denominated in foreign currency (see Chapter XIX, "The Securities Market"); (b) an import of inputs exceeding current production requirements,

i.e. the buildup of stocks of imported goods (see Chapter IV); (c) a capital goods import surpassing the growth of investment itself (see Chapter VIII, "Domestic Investment and Construction"); (d) the advancing of various payments in foreign currency; (e) and the shrinkage of some capital import items, such as personal remittances, investment, etc.

This trend ultimately led to the mounting of the private sector's balance of payments deficit and the absorption of most of the money pumped into the economy by the public sector and the Bank of Israel.

The Bank of Israel was responsible for a substantial part of the liquidity injection (about IL1.5 billion), mostly through its directed credit funds. These funds were established to make credit available for top-priority purposes, notably exports, with the difference between the interest paid on such financing and that on nondirected credit being relatively small. However, with the acceleration of inflation in recent years, and especially since the Yom Kippur War, these funds, which provide financing on unlinked terms, have come to have a growing subsidy element because of the widening differential between the interest paid on directed credit on the one hand and the rise of prices and of interest paid on nondirected credit on the other. The supporting of exports is in itself desirable, given the gravity of the country's balance of payments problem. But the provision of such financing through these funds has had negative repercussions: (a) it results in a much larger liquidity injection than if the support were granted directly through the government budget, and hence it has a harmful effect on the balance of payments; and (b) because the credit supplied by the Export Production Fund is based on the firm's production turnover rate, the volume of such support is governed by criteria irrelevant to the promotion of exports and consequently tends to be discriminatory. Thus, for example, two firms with the same value added in foreign currency may receive widely differing support if they have disparate turnover rates. The linkage of credit granted through the export funds to the exchange rate would lead to a more economical use of such financing without adversely affecting the needs for which it is provided, and therefore it would help to curb the monetary injection and its damaging effects.

Medium- and long-term credit supplied through the financial institutions in accordance with government directives also contains a subsidy element, which in recent years has grown because of the increasing divergence between the interest rate and the pace at which prices have spiraled. The heavier subsidization of investment in this fashion detrimentally affects resource allocation because it warps the relative price of capital. This unquestionably is one reason why the economy was saddled with more unused capacity in the last two years, with all its negative balance of payments implications. This also had

an important bearing on the distribution of income in the economy, causing it to veer in a direction not necessarily compatible with the policy objectives.

Another facet of this problem that deserves attention is that various sectors of the economy enjoy a hefty subsidy without a decision to this effect being taken in the usual manner. According to a cautious estimate, if the subsidy on medium- and long-term credit were given directly, the government would have had to appropriate for this year alone more than IL3 billion (see Chapter XVIII). Hence it obviously would be desirable to restore to the interest rate and credit their economic functions, instead of employing them as instruments for subsidizing the various sectors.

As already noted, the average level of the money supply lagged behind the rise in the general price level (although in the course of the year the two moved up pretty much in step). Other unlinked assets--time deposits and the Short-Term Loan--reveal an even more disquieting picture: the nominal level remained unchanged throughout the year, so that in real terms the balances sank by the full rate of the price rise. These developments were consistent, at least as far as their direction is concerned, with what could have been expected given the advance of prices.

In this context the following should be noted:

(a) As in 1974, the public apparently tended to shed its direct holdings of bonds; however, the switch was chiefly to mutual funds, which essentially constitute a close substitute for direct holdings of such paper. This is indicated by a breakdown of the financial intermediaries' sources of funds, which shows that they bought IL650 million worth of bonds from the public (see Table XVIII-3). This does not imply, however, that the bonds held directly by the public dropped in value; on the contrary, they probably appreciated with the advance of market prices during the year. The bulk of the sales to institutional investors took place in the second half of the year.

(b) Investment in approved savings schemes (net of withdrawals) expanded 28 percent in 1975, but all the increase was in the first half of the year; in the second half the figure fell to its absolute annual level the year before.

(c) The public invested much more heavily in mutual funds--IL1.9 billion as against IL1 billion in 1974. The lion's share of the growth took place in the second half of the year (apparently in the early part), when the level almost doubled compared with the first half.

There were two main reasons why the public was inclined to dispose of part of its direct bond holdings: (a) jitters about possible government action to terminate the full indexation of this paper while institutional savings continued to be fully

inflation-proofed; and (b) the greater variability of price and yield fluctuations among the different bonds, which necessitates considerable expertise in selecting an efficient financial portfolio.

The above refers to the internal composition of the public's financial saving. As regards the total volume, the second half of the year saw a decline of some 15 percent in nominal terms.

According to various national accounts indicators, economic activity turned up in the second half of the year, with a consequent growth of product and consumption alike. No information is available on how private sector saving (as defined in the national accounts) fared, but considering the trends described above, an increase was to be expected during the year. At any rate, it is almost certain that nominal disposable income rose in the second half. The fact that domestic financial saving fell off absolutely suggests that the public preferred to spend more on consumption and the acquisition of foreign currency assets during this period.

The public's disinvestment in domestic financial assets can apparently be attributed to its anxieties about a possible disadvantageous revision of the terms of value-linked savings, and no less important, to its anticipation of a relatively strong rise in the prices of imported commodities and foreign currency assets.

The conclusion that emerges is that, although the liquidity injection was greater than required for financing the balance of payments structural deficit, the conditions prevailing in the economy were not propitious for channeling the excess liquidity to saving in IL financial assets; instead the country's balance of payments position eroded further.

Since the excess liquidity injection is not a heritage of the past alone, great importance attaches to the creation of such conditions as will stave off its damaging effects on the balance of payments. The capital market changes introduced in December (see Chapter XIX) put a damper on government bond sales to the public and institutional investors, making it much harder to cope with the potential liquidity injection built in the current government budget.