

CHAPTER XIX

THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET¹

1. MAIN DEVELOPMENTS

In the course of the year savings within the institutional saving framework of the system accumulated at a very rapid pace. This increase derives partly from the growth in the volume of private saving, but it is primarily the result of a continued process of structural change in public demand for financial assets. It shifted its demand to the indirect holding of index-linked financial assets via the institutional saving framework of the system, as well as to shares and foreign currency assets. This trend characterized the entire year, but was accentuated in its second half. During the second period, redemptions and net sales of bonds from the asset portfolio of the public rose, while the issue of shares increased. In October, following the reform and liberalization of the exchange rate, deposits increased

¹ The institutional structure of the capital market discussed in this chapter is defined as the network of financial intermediaries engaged primarily in the mobilization of medium- and long-term funds for investment in financial assets, such as loans, deposits, and securities. Included in this definition is the group of financial institutions comprising, among others: banks for the development of economic sectors, mortgage banks, investment companies of the various financial concerns, and households finance companies. Also included in this definition are the primary financial intermediaries, namely the social insurance funds, the insurance companies and the mutual funds, as well as savings schemes, the bank's own security portfolios (nostro) and deposits for loan purposes administered by the commercial banking system in parallel with their activity as monetary financial intermediaries (creators of money and grantors of short-term credit). Not included in this definition are institutions financed by a limited number of proprietors and holding companies, the bulk of whose investment is in subsidiaries. This means that the system discussed here covers all institutional non-monetary financial intermediation, apart from direct government operations in the capital market (i.e. operations not carried out by this system, such as direct financing of the local authorities, the issue of securities for households, the collection of compulsory loans from households and business, etc). These direct operations will be incorporated into the system in the future. The system discussed also does not include financial intermediation between the foreign sector and the units of the economy if this is effected by the commercial banking system. For a more detailed description of the statistical and analytical framework, see the Bank of Israel Annual Report 1974, from page 493.

TABLE XIX-1
GROSS MEDIUM- AND LONG-TERM CREDIT, 1975-1977

	Gross credit					Increase or (-) decrease from previous year					
						In prices (Annual average)			In credit volume (real terms)		
	1975	1976	1977		Total	1975	1976	1977	1975	1976	1977
		Half I	Half II								
	(IL million)					(percent)					
A. To households	2,390	3,000	1,600	2,080	3,680						
1. Mortgage credit	1,860	2,100	1,050	1,330	2,380	30.0 ^a	12.4	7.5	-1.3	0.9 ^b	4.9
a. Directed	(1,600)	(1,640)	(820)	(970)	(1,790)	30.0 ^a	12.4	7.5	0.9	-8.8 ^b	1.5
b. For private housing	(260)	(470)	(230)	(360)	(590)	30.0 ^a	12.4	7.5	-13.0	60.8 ^b	16.8
2. Other credit	530	890	550	750	1,300	39.3 ^c	34.3	33.6	-20.7	27.9	8.5
B. To producing and service sectors	3,530	5,110 ^b	3,610	4,400	8,010						
1. Industry	1,650	2,510 ^b	1,650	2,050	3,700	40.3 ^d	25.1	39.5	25.1	21.6 ^b	5.7
2. Agriculture	630	890 ^b	490	660	1,150	37.7 ^d	25.1	37.7	-6.6	12.9 ^b	-6.2
3. Construction	340	360 ^b	310	150	460						
4. Services	910	1,350 ^b	1,160	1,540	2,700	33.1 ^e	29.0	42.1	70.9	11.5 ^b	40.7
C. To local authorities	870	1,140 ^b	740	550	1,290	33.0 ^f	30.0	36.0	-9.1	-7.2	-16.8
Total	6,790	9,250 ^b	5,950	7,030	12,980						

^a According to housing price index, annual average.

^b Revised data.

^c According to Consumer Price Index, annual average.

^d Derived investment data series, at fixed prices.

^e Derived investment data series, of services and electricity, at fixed prices.

^f According to derived public investment price index.

SOURCE: Table XIX-2.

in savings schemes and foreign currency accounts newly opened to the public. The partial diversion of medium- and long-range saving accumulation into foreign currency deposits after the liberalization reduces the volume of resources transferred directly to the institutional system of the capital market and to the government and increases the resources absorbed by the Bank of Israel.

Only part of the increased volume of resources placed at the disposal of the system served to expand credit to households and to the economic sector. The other part was absorbed by the government. It appears that the government increased its absorption from the system in order to offset the reduced absorption resulting from the structural change in the asset portfolio of the public and its impact on the direct financing resources of the government. Total transfer to banking institutions of resources intended for use on the short-term money market was stable this year as well as last year. Stability was due to the advanced acquisitions of securities by the banking system towards the end of the year. This advance served to deflect to the government part of the resource transfer to the banking system.

In summation: net² savings of households and repayments of loans to the system by households and business amounted to IL 16 billion this year, as opposed to IL 10.3 billion last year. Total gross credit granted to households and business increased from IL 8.1 billion to only IL 11.7 billion. As a result, the system's "absorption" from the public rose from IL 2.2 billion to IL 4.3 billion. This rise, as mentioned, served principally to increase the transfer of net resources to the government.

The continued trend toward structural change in the asset portfolio of the public and the intensification of this trend stem to a certain extent from changes in relative yield which favor institutional savings. However, the central factor in this process appears to be the effect of weakened public confidence in linked securities, mainly in those of the government. This is a result of a continuous chain of actions, declarations, and explanations regarding the ability and intention of the government to meet its financial obligations. An erosion of public confidence took place towards the end of the year; the expectations concerning an improvement in the terms of securities provided an added inducement to postpone the acquisition of securities of the existing type.

² Data here are different from those given in the tables contained in this chapter, since they also include the direct acquisition of government securities by the public, See section 2 C below.

The volume of resources deriving from current payments on account of past liabilities is similar this year, as in the previous year, to the volume of resources supplied by household savings. The extent of these payments was determined by grants of credit awarded and terms established in the past, hence it is not subject to the influence of current developments in the economy. Despite its negative real interest rate, the repayments on this credit had become central to the financing of current investments in the economy, given the huge volume of resources previously placed at the disposal of economic sectors and households. Changes in the channels of investment incentive should therefore be made with care, lest a measure bearing harmful side-effects be chosen. Such a course could damage the current volume of repayments, which will in turn encumber the financing of future investments by creating such difficulties as a prolonged period of repayment for development loans.

The gross volume of medium- and long-term credit, granted by the system to households, to economic sectors, and to local authorities increased in 1977 by about 40 percent and amounted to about IL 13 billion. In real terms, the growth rate of credit to households (following the recovery of the construction branch in the second half of the year) and of credit to services (stemming from a considerable acceleration of investments in power) increased. On the other hand, the growth rate of credit to industry and agriculture decreased, and credit to agriculture actually showed a real decline. Credit granted to local authorities by the system decreased at a not-insubstantial rate. However, since part of the financing of local authorities has been transferred to other frameworks, not included here, one should not deduce the amount of resources placed at their disposal from this.

Investment financing credit in industry increased in real terms by about 6 percent, as opposed to about 22 percent last year. However, given the nearly 17 percent drop in industrial investments, the figures translate into a considerable increase in the system's share of financing investments from its resources.

This share amounted to 75 percent, as opposed to 60 percent last year and about 44 percent in the preceding two years. If the investment grant, which is not included here but appears in the expenditure budget of the government, is added, the proportion of investments in industry financed by public funds (both credit and grants) totals nearly 90 percent.

Rates of interest on directed credit to most households and to economic sectors have been raised significantly in recent years. The rate in the economic sectors fluctuated at the end of 1977 between 17 and 22 percent, and reached about 30 percent in mortgage credit. Given the inflation rate prevailing during these years, this interest rate still com-

prises a considerable subsidy. However, this is long term credit, and, should the inflation rate subside in the coming years, the subsidy volume will decrease drastically, and interest of part of the mortgage credit might reach very high real rates. A different method for determining interest rates, and particularly one that connected interest rates to the pace of price increases, could have maintained a constant and foreseen volume of subsidy, especially during years characterized by changing inflation rates.

Part of the substantial increase in the rate of financing for the last two years is due to an officially sanctioned deviation from accepted criteria governing the Law for the Encouragement of Capital Investments. This was the "complementary financing", arrangement via which credit totalled about 15 percent of total investments this year. In addition the special financing arrangement with Hevrath Haovdim continued to expand. The possibility of obtaining credit beyond accepted criteria by exploiting foreign credit lines while assuming interest rates somewhat higher than those customary in development credit exists, but apparently it was not extensively exploited. Nevertheless, these frameworks do not fully explain the increased share of financing.

It is possible that investment estimates in industry in the last two years were considerably deflected downwards³, and if we also include the effect of the lag between the implementation of the investment and the actual receipt of the credit (due to the reduction of the volume of investment in the economy), then the rate of financing for current investments was lower than 75 percent. This rate is still higher than last year, and exceeds preceding years by even more. In the agricultural sector, too, the rate of financing increased somewhat, and it amounted this year to 77 percent of total investments.

The government has a central role in determining the nature of activities in the institutional system of the capital market. The government directs and guides it directly and, through it, the investment activity in the economy as well. This already solid status was even buttressed to a certain extent in the course of the year. This development is tied to the increased rate of compulsory investments in securities that was imposed on part of the primary financial intermediaries. It is likewise connected with the development of the framework of long-term linked deposits, which injects, or places directly at the government's disposal, most of the money it mobilizes. The increased share of investments financed from public resources also contributed to this process. The reinforcement of the government's central role stems partially from institutional changes created by current

³ This possible deflection stems from the method of estimation and the debiting of the prices of assembly and installation of equipment. See Chapter IX.

governmental decisions (such as the increase in the rate of compulsory investments from accumulated savings). It also stems from the inability of the system's institutions to find other uses for undirected capital and provide return rates adequate to the cost of the resources (a cost determined by the government), in order to render them competitive with revenue on deposit with the Treasury. Although at the beginning of 1978, the ceiling on permitted investment of social insurance funds in shares and convertible bonds was raised as a step intended to expand the system's freedom of financial investment, the results are as yet unclear.

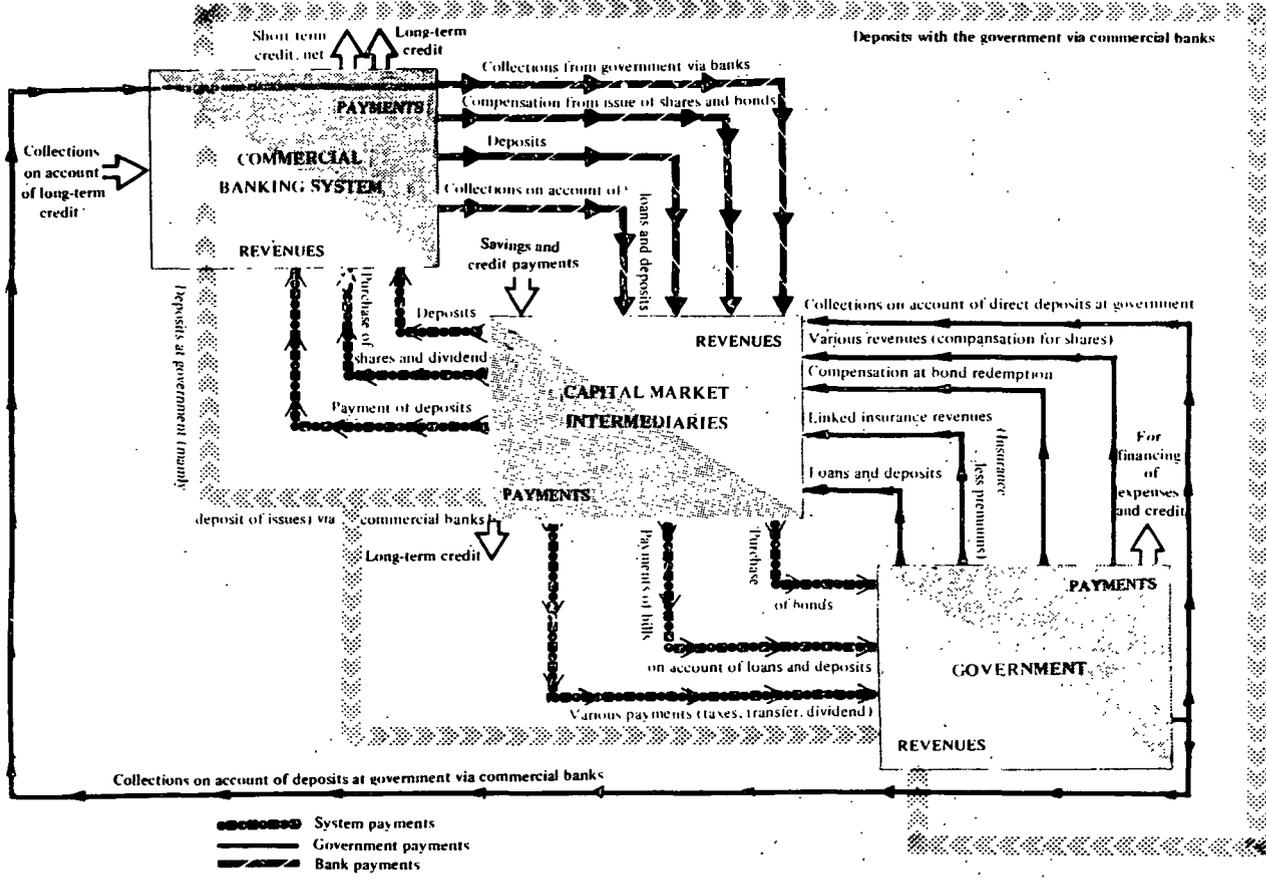
I. OVERALL ANALYSIS

1. GOVERNMENT INFLUENCE ON THE SYSTEM

The extent of the government's involvement in determining the character and level of institutional activity in the capital market as discussed in this chapter is far greater than what appears from the share of direct financial transactions between the system and the government. In fact, the government's involvement is discernible throughout the entire process of financial mediation by the system: (a) it occurs at the stage of mobilizing the "primary" resources of the system (mainly from households, through social insurance and pension funds, insurance companies, savings schemes and trust funds); (b) at the intermediate stage of financial mediation within the system – the transfer of most mobilized resources to frameworks of secondary financial intermediaries, i.e. the financial institutions and the earmarked deposits with the banking system. This is effected via the purchase of securities and by making deposits available for the granting of loans by the primary financial intermediaries; (c) at the final stage of financial mediation, when the financial means are placed at the disposal of the various economic sectors and households to finance their activities as producers and consumers.

In the first stage, the government ensures that the lion's share of voluntary financial saving in the economy finds its way to the financial framework of the system. It is the government which permits these frameworks to guarantee the saving public directly or indirectly, amidst any rate of inflation, a positive long-term real rate of return, of up to 5 percent. This is on top of income tax breaks on earnings from the saving, and, in some of the frameworks, tax credits on initial deposits. Thus, the government has in fact prevented the development alongside the system discussed here of a large volume capital market that could compete for the mobilization of domestic financial resources. Yet it can be assumed that government intervention has a considerable positive influence on the level of savings in the economy, particularly during times of rapid inflation.

FIGURE XIX-1
**MUTUAL RELATIONS BETWEEN CAPITAL MARKET INTERMEDIARIES
 AND THE GOVERNMENT AND THE COMMERCIAL BANKING SYSTEM**



As to stage (b): the government ensured that most of the mobilized resources would be channeled to the acquisition of bonds, governmental as well as those of financial institutions, through regulations requiring the primary financial intermediaries of the system to devote 80 and 92 percent of their resources to the purchase of the same (they enjoy the status of approved investments).

Concerning stage (c): regulations exist to the effect that any financial institution seeking to mobilize financial resources through the flotation of bonds (and the issue of securities in general) has to obtain special permission for this; this particularly applies to an institution requesting that its issues be recognized as "approved investments" (for the purposes of regulations governing investments of primary financial intermediaries). The government can make the granting of the "permit" and the "recognition" contingent upon its right to direct the uses of the capital (wholly or in part). In fact the government makes extensive use of this prerogative, by directly or indirectly manipulating the lion's share of resources thus mobilized by financial institutions to accord with its development policy. An expression of this policy is the granting of unlinked loans bearing relatively low nominal interest rates to high priority activities and needs. The government essentially serves as a conduit between funds raised via its own bond issues — governmental or those of financial institutions (under identical terms) — and those monies which are channelled back to the financial institutions for the sake of granting cheap loans under government direction. In the interim, these funds are deposited with the government, and the terms of deposit take into account the conditions for granting credit, as well as the profit margin that must be guaranteed the financial institutions.

In fact, the bulk of medium-and long-term credit granted by the institutional system of the capital market is government directed and disbursed as cheap and unlinked credit. It is the public sector that covers linkage differentials. The relatively small portion of proceeds from the bond issue of financial institutions defined as "free" of government control also serves primarily as the institution's "own" share in providing resources to finance cheap credit. Alternatively this portion serves to finance the government, since the institutions want to guarantee that the Treasury will cover linkage differentials.

In order to get an overview of government influence on the activity of the institutional system of the capital market, it is necessary to mention the mobilization of funds abroad as well. Given the limited ability of financial institutions to grant loans linked to foreign currency, they generally submit these resources to the guidance of the public sector in return for coverage of exchange rate differentials. The volume of resources thus mobilized is in fact minimal. Following the liberalization and the reform in the exchange rate, not every foreign loan requires specific approval, but advantages to obtaining coverage of

exchange rate differentials remain. In summation it can be said that the influence of the government on the nature and the level of activity in the system is most extensive.

At the same time, the institutional system of the capital market retains a relatively small sphere of independence in granting medium-and long-term credit free of government direction. The principal financial sources of such credit are free resources of social insurance and pension funds, the insurance companies and savings schemes (in the framework of voluntary acquisition of securities), as well as resources supplied by business and other factors. The volume of these means depends to a great extent on monetary developments and the liquidity situation of the economy⁴.

2. FINANCIAL RESOURCES AT THE DISPOSAL OF THE SYSTEM

A. INTRODUCTION⁵

The principal financier of the system is the household sector, which contributes to the system's financial resources mainly via saving in social insurance and pension funds, insurance companies, savings schemes and trust funds. In the years preceding 1974, the contribution of households to the financial resources of the system increased through direct acquisition of securities issued and/or sold by the system on the secondary market. Since 1974, this component has become negative, i.e. there was a net public redemption, or redemption and sale to the system, of securities on the secondary market, mainly to trust funds. While the scope of contribution from households to the system's resources through savings in social insurance funds and other primary intermediaries can be directly identified, their contribution through the acquisition of securities cannot be isolated. However, one can make an estimate by comparing the net revenue from the issue and redemption of securities and the system's transactions in securities with households. This revenue also includes a relatively small component of the net financial outcome of business transactions on the secondary market.

Businesses are not only credit consumers in the system, but also suppliers of resources (in relatively modest volume) to it in the form of deposits for granting loans (mainly for financing households and local authorities). They also purchase securities issued by the system on the primary market. Monies transferred to the system by the State Lottery, mainly for financing local authorities, can also be included, although in the course of the

⁴ It should be remembered that the financing institutions of "Hevrath Haovdim" received general permission to use an agreed part of the resources they mobilize for financing investments in the framework of the financial program of "Hevrath Haovdim", and these too are entitled to linkage differential insurance.

⁵ See Table XIX-2.

TABLE

SOURCES AND USES OF MEDIUM- AND LONG-TERM

(IL million, on the

Sources	1975	1976	1977
Household savings, net of withdrawals	6,050 ^a	6,580 ^a	12,000
Business deposits and sale of securities (net)			
Net receipts from household and business ^b	310	300	-70
securities transactions	-650 ^c	-780	-1,810
Total	5,710	6,100	10,120
Loan repayments from:			
Households	1,150	1,460	2,370
Business	1,760	3,340 ^a	6,030
Local authorities	630	900 ^f	1,260
Subtotal	3,540	5,700 ^a	9,660
Other sources			
National Institutions (net)	190	260	200
Rest of the world (net) ^d	280	410	390
Others ^e	0	100	390
Subtotal	470	770	780
Total sources	9,720 ^a	12,570 ^a	20,560

NOTE: Receipts and payments on account of medium- and long-term debt repayment, savings withdrawals, and redemption of securities include not only the principal but also interest and linkage differentials paid. In the flow-of-funds system these components were previously defined as real (i.e. nonfinancial) transactions and included in the surplus of income over expenditure. In the present system the "surplus of expenditure over income" includes, in addition to payroll, service charges, purchases of assets, etc., only interest received and paid on short-term credit transactions. It should not be concluded from this that the intermediaries wind up the year with an operating loss; most of the interest and linkage differential items in their financial statements are included under other items in this table or are totally excluded from the system.

a Revised data.

b The net proceeds from securities transactions with households and business (see the detailed explanation in Section 2 of the 1977 Annual Report, p. 393).

FUNDS -- CAPITAL MARKET INTERMEDIARIES, 1975-1977

basis of cash flows)

Uses	1975	1976	1977
Gross medium- and long-term credit to:			
Households	2,390	3,000	3,680
Agriculture	630	890 ^a	1,150
Industry	1,650	2,510 ^a	3,700
Construction	340	360 ^a	460
Services (incl. electricity)	910	1,350 ^a	2,700
Local authorities	870	1,140 ^a	1,290
Total	6,790	9,250 ^a	12,980
Net transfers to:			
Government	1,660	910	3,870
Banking institutions	(-10)	220 ^a	220
Total	1,650	1,130 ^a	4,090
Short-term uses, net ^c	580	1,110	2,020
Surplus of expenditure over income ^c	920	1,180	2,180
Dividends	180 ^a	230 ^a	340
Other payments, net ^b	-400	-330	-1,050
Total uses	9,720 ^a	12,570 ^a	20,560

^c The increase in outstanding short-term assets, including cash and demand deposits, less the increase in outstanding short-term liabilities (including short-term items in connection with allocations to reserves and other bookkeeping entries, and including cash reserves and foreign currency and Natad deposits). Including also demand and short-term deposits in banks amounting to about IL million in 1977, about IL 500 million in 1976 and an unknown sum in 1975.

^d Including short-term transactions of the system abroad.

^e Mainly dividends received.

^f Taxes, premiums and claims from general insurance, revenues and payments in connection with reinsurance.

SOURCE: Estimates of the Research Department, Bank of Israel.

second half of 1977 the State Lottery began transferring money through the Accountant General of the Treasury.

Additional sectors making a modest contribution to financial resources of the system are the national institutions and the foreign sector, as well as other sources of income, mainly dividends on shares held by trust funds and others.

Monies received from current payments (fund, interest and linkage differentials) on the obligations of credit consumers: households, businesses and local authorities constitute a substantial reservoir for financing.

Not all the funds from the financial resources detailed above are used to grant credit to producers and consumers in the economy. Part of these resources are absorbed from the system by the government and by banking institutions whose financial relations with the institutional system of the capital market are discussed in this chapter (see Figure XIX-1, presenting the main interrelationships between the institutional system of the capital market and the government and banking institutions). Government absorption from the resources of the system are both measures of fiscal policy and means to finance government activities, including the repeated injection of financial resources to the system. The banking institutions, which play the role of "coordinators" in the various financial concerns, channel to themselves many of the system's resources and subsequently return most of them to the system after redistributing them among the system's secondary financial intermediaries. On the one hand, the financial institutions of the system transfer to the banking institutions with which they have relations of proprietorships most of the financial means which they have mobilized (mainly monies from bond issues, but also other financial resources, such as saving funds, loans, and deposits from both domestic and foreign sources, etc.). Part of these resources are transferred to the banking institution, which either deposits them with the Treasury or grants loans in the name of the transferring institution. Another part is deposited for an unspecified purpose. On the other hand, the banking institution transfers to financial institutions connected with it various deposits, as its share in financing their activities, as well as interest repayments on deposits. This ramified system of connections, and particularly transactions arising from the role of banking institutions as transfer points for these funds, contributes greatly to the increase of the balance assets and liabilities in the accounts of the banking institutions. It is certain that at least some of these transactions are intended to inflate the balance sheets, and serve no other commercial purpose whatsoever. The lack of coordination during the year between fund flows from the system to the "banking sector" as discussed here and reverse flows, and with that portion of mobilized savings in savings schemes which does not require recognized investment and is hence not invested in securities can affect the

current liquidity level of the banks, and thus the dimensions of their deficits. The institutional system of the capital market therefore constitutes a kind of regulator that is able to transfer liquidity deficits (or injections) from the government to the banking system and vice versa.

B. DEVELOPMENTS IN THE VOLUME AND STRUCTURE OF THE RESOURCES

In the course of 1977, there was a definite acceleration in the volume of resources placed at the disposal of the institutional system of the capital market. This resulted from a considerable increase in the volume of savings of households in various savings schemes of the system and from a growth in credit repayments equivalent to last year. Total resources in real terms increased this year by 22 percent, contrasting with a decrease of about 2 percent in 1976, and reached a volume of IL 20.6 billion. Of this amount, total net savings increased by 35 percent, as compared with a decrease of about 17 percent in the previous year, while the repayment of loans increased by about 26 percent, as against 23 percent last year. In the other items there was a decrease in the volume of resources placed at the disposal of the system.

The substantial growth in the volume of savings directed to the system is related to two phenomena. There were changes in saving rates of the private sector in the course of the year, as well as changes in the composition of the public's financial portfolio (see section C below); as mentioned, these developments acted in unison to increase, the volume of resources directed to the system.

The ratio between the volume of financial transactions effected in the course of the year by institutions of the system and the volume of medium- and long-term credit also increased considerably this year, and stood at 4.7 as against about 4 in the last two years. This large gap is mostly related to the multi-tiered interim financial mediation, which makes no positive contribution to the capital market and does not advance the possibility of establishing real control by the public sector over the volume of resources which it subsidizes⁶. The problem was exacerbated this year by the propensity of the public to deflect its demand from the holding and direct acquisition of bonds to institutional saving (in savings schemes, social insurance funds, etc.). This development widened the gap and aggravated the problem.

⁶ Although, because of the specialization of primary and secondary intermediaries, it is reasonable that there should be a certain gap between the volume of credit and that of transactions. But it should not be as wide as in the Israeli economy, and there is certainly no reason to desire the further widening of this gap, such as occurred this year.

In the structure of resources, the proportion of household savings in total resources stabilized at 49 percent this year, a level similar to last year, after having experienced a continuous decline from the 1974 level (63 percent). In tandem, the weight of credit repayments, which had increased continuously in previous years, also stabilized. This stabilization is rooted in the accelerated channeling of household savings to the system and not in developments in the sphere of credit payments; in this field, the trend towards increased interest rates, as well as an abbreviation of the credit period⁷, contributed to an acceleration in the growth rate of payments.

The process of adjustment between supply and demand in medium- and long-term credit sources is regulated only to a limited extent via the mechanism of changes in interest rates (affecting only surplus demand of the public from the system) and to a larger extent through the government. The government's rationing of credit and its withdrawal of a net volume of resources from the system to finance its credit needs can serve as an illustration. The proportion of resources thus withdrawn from the system is subject to extensive fluctuations: the amount this year totalled 19 percent, as against 7 and 17 percent in 1975 and 1976 respectively. The increased transfer of net resources to the government that took place this year is linked, together with the developments cited above, to changes in the composition of the household portfolio. The households' shift from direct acquisition of bonds (mainly governmental) to investment in institutional frameworks (which purchase bonds of financial institutions with most of these funds) led to the diversion this year of part of the savings that had previously streamed to the government to the institutional system of the capital market. This development was expressed in the decreased proportion of government bonds in total voluntary issues of bonds, which fell to 12 percent this year, as against 20 percent last year and 35 percent in 1975. It can be assumed that a considerable portion of the increased transfer of net resources to the government (from about IL 900 million last year to about IL 3.9 billion⁸ this year) can be attributed to a desire to offset the influence exerted by the changing structure of public demand on resource allocation in the economy.

In addition to the government, the commercial banking system taps the institutional system of the capital market, to a certain extent, to supply the requisite resources for financing its activities on the short-term money market. The volume of resources absorbed

⁷ The average credit period for a number of types of credit, mainly credit to households granted by mortgage banks and social insurance funds, but not to economic sectors.

⁸ This sum is somewhat deflected downwards, since it does not include credit to the government in the framework of long-term linked deposit; see section C.

by the commercial banking system stabilized this year in nominal terms, and as in the previous year amounted to IL 220 million. It seems that in 1977, as in 1975, this amount is to a certain extent deflected downwards, owing to the advanced acquisitions of bonds (following the reform of the exchange rate) by the banking system. In addition to absorbing long-term resources, the institutions of the system deposit with the commercial banks current as well as fixed-term deposits as part of the liquid assets or for interim uses. These deposits (see Table XIX-2) increased in the course of the year by about IL 580 million, as opposed to IL 500 million last year.

The proportion of net resources transferred from abroad also decreased this year in absolute terms, with volume totalling only IL 200 million. Gross resources increased 6- to 8-fold, while changes in the resource base of financial mediation also occurred this year. Resources were primarily gathered by exploiting the credit lines of banks or of suppliers⁹, whereas in the past the issue of bonds had served as the principal method of capital mobilization abroad. Most of these resources are directed by the government, since they benefit from exchange rate insurance through the Account General.

C. RESOURCES OF THE SYSTEM FROM HOUSEHOLDS AND BUSINESS

Contrary to last year's development, there was a considerable increase in the volume of savings supplied by households to the system's various saving institutions this year. Total net savings directed to the system's institutional savings schemes increased in real terms by about 35 percent, as opposed to a decrease of about 17 percent last year and stability in 1975. This substantial rise derives partially from an increase in the volume of savings of the private sector (which increased this year in real terms¹⁰ by about 14 percent, as against a decrease of about 30 percent last year). However, it seems to come primarily from the accentuation of the change in the structure of public preference for financial assets, which shifted from the direct holding of bonds to institutional saving. This development characterized the entire year, but was more prominent in its latter half, and particularly in the initial days following the exchange rate reform, a step that raised expectations of a rapid and immediate price increase. It is also possible that the recovery of savings by the private sector this year was restricted to financial channels at the expense of real channels, and particularly housing. This fact prompted the rapid acceleration of these savings components.

⁹ In addition to credit lines from abroad, it is also possible that the commercial banking system utilizes other credit lines for granting medium- and long-term credit to enterprises and not through the system. This financing does not appear in data presented here.

¹⁰ After deduction of the annual average increase of the Consumer Price Index.

TABLE XIX-3
FUNDS SUPPLIED TO THE SYSTEM BY HOUSEHOLDS, BY SOURCE, 1975-1977

	1975	1976	1977		Total	Increase or (-) decrease compared to previous year			Increase or (-) decrease compared to previous year in real terms		
			Half year I	Half year II		1975	1976	1977	1975	1976	1977
			(IL million)								
Social insurance fund savings ^a	1,740	2,160	(1,680)	(2,170)	3,850	15	25	78	-17	-5	32
Approved savings schemes ^{a,b}	2,190	2,460	(1,620)	(4,110)	5,730	29	12	133	-7	-15	73
Mutual funds ^a	1,670 ^d	1,340 ^d	(1,060)	(450)	1,510	85 ^d	-20 ^a	13	33	-39	-16
Life insurance ^a	450	620	(380)	(530)	910	41	38	47	1	5	9
Subtotal	6,050 ^d	6,580 ^d	(4,740)	(7,260)	12,000	37 ^d	9 ^a	82	-2	-17	35
Net receipts from security transac- tions - households and business ^c	-650	-780	(-250)	(-1,560)	-1,810	-	-	-	-	-	-
Total	5,400 ^d	5,800 ^d	(4,490)	(5,700)	10,190	41 ^d	7	76	1	-18	31

^a Deposits (or premiums) less withdrawals of principal, interest, linkage increments and dividends (or claims).

^b Including bank savings programs and savings programs for housing and education.

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

^d Revised data.

SOURCE: Estimates of the Research Department, Bank of Israel.

Following the reform in the exchange rate at the end of October, foreign currency financial investment channels were opened to Israeli citizens. They had previously been permitted only to a segment of the population or to funds deriving from certain sources, and their use was severely restricted. The option to diversify the composition of the portfolio led to a reduction in the proportion of index-linked bonds in it. It should be emphasized that the accumulation in foreign currency accounts of the banking system, in lieu of the acquisition of governmental or institutional bonds, does not immediately and directly place resources for the granting of credit at the disposal of the government or the system. In the first months following the reform in the exchange rate system, and particularly at the beginning of 1978, there was an extensive accumulation of foreign currency deposits. This in effect reduced the volume of resources at the disposal of the system.

The decreased public demand for the direct holding of bonds was expressed by a continued decline in retention of securities issued by financial institutions of the system (net sale and redemption of bonds was IL 1.8 billion this year as against about IL 0.8 billion last year), and a more severe decrease in the acquisitions and retention of government bonds (whose weight in the household's portfolio exceeds their proportion in the total portfolio): net redemptions and sales of these bonds are estimated at about IL 2.5 billion this year, as opposed to about IL 0.6 billion last year¹¹.

Partially underlying this change in the preference structure for financial assets is the increased demand for stock holding. However, the principal reason is the transition towards acquiring linked financial assets within the framework of institutional saving (savings schemes, social insurance funds and life insurance). This development in turn is partly tied to changes in the relative yield of the various savings channels: the yield on bonds declined in the past year more than the yield on institutional saving. Yet the prime motivation for the altered preference is the continued erosion of public confidence in linked bonds, and particularly government bonds, in the wake of measures, declarations of intent, and comments by the government, public personalities, and various commentators in the course of previous years. The modified composition of the financial asset portfolio contributes to a reduction in its liquidity, which from the vantage point of the economy contributes to a more favorable structure of investment financing. At the beginning of 1978, interest rates on bonds were raised for the second time in a few months, and terms offered to the public were diversified. This may augur a favorable turnaround in this field.

The greatest amounts of savings were accumulated in the savings schemes of the commercial banks, mortgage banks and other banks, which also displayed the highest rates

¹¹ This activity does not appear in this chapter, since government bonds are not yet included in the system under review.

in institutional saving this year. The rate of accumulation had already increased in the first half of this year (from 12 percent in the course of 1976 to 32 percent per annum in the first half of 1977), as a result of the aforementioned trends in the structure of the public's asset portfolio. During the latter half of the year a dramatic increase in the rate of deposits within this framework ensued, and the rate climbed to 234 percent per annum. This jump stemmed from two developments particular to this period. The first was touched off in July and continued for a few months, when a medium-sized bank pierced the "uniform terms" barrier in bank savings schemes. It offered improved terms in order to attract savings (an increased grant to the saver, improved linkage to the price index and the partial linkage of the savings scheme to foreign currency). This daring act of breaking with uniform banking prices (which was accomplished at the expense of the bank's profit margin and without the government providing additional revenue) on so central an issue as the savings schemes was accompanied by an extensive publicity campaign. This was an unheard-of phenomenon in banking circles during recent years, and it caused quite a stir. Fearing to lag behind, the other banks hastened to imitate the "pioneering" bank and mounted a campaign to woo the saver, based on publicity and practical inducements such as a considerable savings terms. The effect of these measures was an increased rate of accumulation. It should be emphasized that towards the end of the year, the banks began to coordinate their terms again, and the special benefits were cancelled.

The second development, although short-lived (lasting only about one week) contributed to an extensive accumulation, estimated at about IL 2 billion. This was the extension of a temporary arrangement (in force in October: International Saving Month) to the first week of November, following the reform of the exchange rate. Under this arrangement, the public's deposits in savings schemes during that week were linked to the index of September (instead of that of the current month, as usual). Thus the depositor benefitted from the October index rise (3.6 percent) and anticipated a significant increase of the price index in November in the wake of policy measures¹². It is possible that part of the increase in deposits was tied to the realization of development profits and the desire to secure additional compensation through linkage to the price index.

¹² In fact, the price index increased in November by about 12 percent.

¹³ The weighted average interest on directed mortgages increased from 9 percent in 1975 to 11.5 percent in 1977, and free (non-directed) mortgages from about 19 percent to about 27 percent respectively (Price Monthly, Central Bureau of Statistics).

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TABLE XIX-4

FLOW OF FUNDS BETWEEN THE SYSTEM AND THE GOVERNMENT AND BANKING INSTITUTIONS, 1975-1977
(IL million)

Sector	Type of receipt o/a payment	Receipts o/a long-term assets ^a	Payments o/a long-term liabilities ^a	Surplus of current receipts over payments (1)-(2)=	Current long-term receipts ^b	Current long-term payments ^b	Surplus of current receipts over payments ^b (4)-(5)=	Total surplus (3)+(6)=
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
Government	1975	2,870	490	2,380	1,820	5,860	-4,040	-1,660
	1976	4,230	690	3,540	2,630	7,080	-4,450	-910
	1977	8,130	1,230	6,900	4,180	14,950	-10,770	-3,870
Banking institutions	1975	1,060	480	580	1,490	2,060	-570	10
	1976	670 ^c	860	-190 ^c	1,950	1,980 ^c	-30 ^c	-220 ^c
	1977	350	1,290	-940	2,270	1,550	720	-220

Note in relation to the government: Column (1) mostly repayment of past deposits by the Accountant General, and Column (2) mostly payment of working deposits of the Accountant General.
Column (4) mostly working deposits of the government.
Column (5) mostly deposits from emissions.

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

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

^c Revised data.

SOURCE: Estimates of the Research Department, Bank of Israel.

These developments led, as mentioned, to a greatly increased accumulation in savings schemes, amidst reduced interest rates. The ceiling on saving amounts permitted in one account was doubled. The expectation that the terms of bonds offered to the public at large would improve led to the deferred acquisition of new bonds in order to avoid capital losses. This trend also pushed in the same direction.

Social insurance funds also displayed considerable momentum this year: total accumulation increased in real terms by 32 percent, compared with a decrease of 5 percent last year. This development derives mainly from the growth in demand for institutional saving described above. It was also facilitated by a substantial increase in the amount of deposits by the Treasury (for a detailed description, see the second part of this chapter).

In life insurance, accumulation continued at a somewhat more rapid pace than last year, growing in real terms by 9 percent, as against 5 percent in 1976. The explanation for this development is that life insurance is primarily linked to the price index. Revenue from premiums is adjusted to the changes of the index. Thus, a certain accelerated growth in the amounts of life insurance policies took place.

Savings in trust funds was the only channel which declined this year in real terms. However, its rate of decline was lower than last year, as it fell by 16 percent, compared to 39 percent. In trust funds specializing in linked bonds, the decline in accumulation persisted primarily for the same reasons that affected the direct holding of these bonds. Trust funds investing only in shares did not issue new certificates this year. It appears that the fact that funds sold only "packages" of shares and bonds, when demand for shares was very high, helped stave off an even steeper decrease in the volume of bonds issued.

In addition to the saving frameworks reviewed, deposits in a relatively new framework increased this year, namely long-term linked deposits. In this framework, managed by the banking institutions, large deposits (a minimum of IL 0.5 million) linked to the cost-of-living index are made and left on deposit for a period of at least two and a half years. These funds are apparently used for the granting of index-linked loans to local authorities and to the Accountant General. In the course of 1977 almost IL 400 million were deposited in these accounts. It seems that these deposits originate mainly from nonprofit institutions, and they developed as a substitute for direct investment in bonds. In the absence of detailed information, an analysis of the new saving framework is not possible.

D. RESOURCES OF THE SYSTEM FROM PAYMENTS OF CREDIT CONSUMERS

The financial resources of the system which originate from credit payments of past borrowers on account of obligations increased this year by about 70 percent and amounted to IL 9.7 billion. This constitutes about 47 percent of total resources, and is similar to last year's level. The nominal volume of this source of financing is determined by previous credit-granting activities (the volume of loans, their period and interest terms), and it is of households or its composition. For example: if the trend in household savings had represents a stable source of financing, which is independent of the current savings volume of households or its composition. For example, if the trend in household savings had persisted this year along the lines of last year, the volume of payments would have climbed by 50 percent, while in fact it was similar to the current savings of households, (IL 9.7 billion, as against IL 10.1 billion in 1976). The importance of this source of finance to the system obliges policy makers desirous of encouraging and subsidizing investments in the economy (particularly when determining the period of the loan and the interest rate) to weigh carefully the consequences of their policy measures on resources that will be available to the system for the financing of future investments. In the last few years, the increase in nominal interest rates and the reduction of the average period in certain types of credit (mainly mortgage credit and credit to members of annuity funds) helped increase the amounts of repayment. However the high and continuing rate of inflation served to neutralize the effect of this increase on the real volume of payments.

E. THE ABSORPTION OF RESOURCES BY THE GOVERNMENT AND BY THE BANKING SYSTEM

The proportion of the net absorption by the government from the system's resources is, as mentioned, subject to considerable fluctuations owing to a number of factors (see Section B). In any case it does not fully reflect the government's involvement in the activities of the system.

The mesh of the government's financial ties to the system is very complex indeed. In general, it can be said that these connections possess four dimensions (see Table XIX-4 and Figure XIX-1):

(1) The government receives its share of total financial resources mobilized by the system, mainly through the deposit of part of the emission funds issued by the financial institutions, as well as via the sale of government securities to the various frameworks within the system (see column 5 in Table XIX-4). There was a considerable increase this year in this item due to increased redemptions and repeated flotations of bonds to frameworks of institutional saving, and due to the change in the savings channels of the public.

(2) The government deposits funds with the various financial intermediaries of the system for the granting of loans under their direct guidance (see column 4 in Table XIX-4). In recent years, the proportion of this item increased substantially as opposed to the granting of linkage insurance free of deposit with the Treasury or redeposit in the financial institution.

(3) The government repays linked debts to the system on account of its obligations, mainly those mentioned in paragraph 1 above (column 1, Table XIX-4). This year's large increase in this item is connected partly to the vast expansion (more than 100 percent) in the redemption volume of bonds previously issued by the system, and whose proceeds were transferred to the Treasury.

(4) The government receives cash payments from the system on account of its assets, mainly those mentioned in paragraph 2 above (see column 2 in Table XIX-4). The amounts in this column are relatively low, since these payments to the government derive mainly from unlinked revenue bearing very low interest rates that were set years ago.

Total net government absorption increased considerably this year, and amounted to about IL 3.9 billion. However, this fact does not reflect a change in the government's policy towards the system, but rather its attempt to neutralize, via loans from the public, the influence exerted by changes in the composition of the public's asset portfolio on government financing.

It is worth emphasizing in the account of revenue and payments for assets and liabilities, the government is a large-scale supplier of net resources to the system (IL 6.9 billion this year). This is mainly due to the gap existing between the terms of the system's deposits with the government (linked to the index in tandem with the system's self imposed obligations) and the terms of the government's deposits with the system (relatively low interest, no linkage, in conjunction with interest terms on loans which the system places at the disposal of economic sectors). This amount expresses the annual current cash register of the government's subsidy of saving and investment in the economy through the system.

In contrast, the government, in the account of revenues and current payments (stemming from the actions of the current year) absorbed resources from the system at a substantial volume (IL 10.8 billion this year). The net total of government absorption is, as mentioned, IL 3.9 billion.

The web of financial connections between the banking sector and the institutional system of the capital market discussed in this chapter is not less complicated than that between the system and the government. Banking institutions, as mentioned, play the role of financial resource "coordinators" in the financial concerns that are grouped around them.

TABLE XIX-5

**GROSS MEDIUM- AND LONG-TERM CREDIT AND VOLUME OF BUSINESS^a OF
THE SYSTEM IN THE CAPITAL MARKET, 1975-1977**
(IL million)

	1975	1976	1977
1. Gross medium- and long-term credit	6,790	9,250 ^b	12,980
2. Financial dealings within the system	9,730	11,930	22,730
3. Financial dealings of the system with other sectors (revenues)	18,120 ^b	23,350 ^b	38,330
4. Total volume of financial business (revenues) (2+3)	27,850 ^b	35,280 ^b	61,060
5. Ratio between gross credit and total business volume of the system (1)/(4)	4.1	3.8	4.7

^a Only includes business connected with the granting and receipt of financial means for the medium and long term.

^b Revised data.

SOURCE: Estimates of the Research Department, Bank of Israel.

A concern generally includes social insurance funds, insurance companies, savings schemes, trust funds, investment companies, development banks, and mortgage banks. In this framework, the large banks channel to themselves a considerable part of the system's resources. Most of these resources are returned to the system, after their redistribution among the secondary financial intermediaries of the system. The banking institutions mostly serve only as "transfer points" for funds earmarked in advance, and thus we shall present in the system of tables either the destination, or the source, of the monies in transit.

The absorption of means by banking institutions this year was low, amounting to IL 220 million. As in 1975, this phenomenon could be explained, at least partially, by the advanced acquisition of bonds by the banking institutions in the last quarter of the year, following the introduction of policy measures in October.

3. CREDIT BY THE INSTITUTIONAL SYSTEM OF THE CAPITAL MARKETS, ITS TERMS AND DESTINATIONS

A. TERMS OF CREDIT GRANTED

Most of the gross medium-and long-term credit granted by the system is cheap unlinked credit. It is granted according to the public sector's directives and at its expense. This applies particularly to credit to households and the agricultural and industrial sectors. Some of the credit granted, mainly to local authorities, and a small portion to economic sectors, is linked. The system presented here supplies most of the medium-and long-term credit to the economic sectors and households. But simultaneously credit of this type is also granted directly by the government and by the commercial banks utilizing foreign credit lines as well as long-term linked deposits.

Directed credit granted by the system following government guidelines for financing investments in economic sectors is not linked and bears a relatively low nominal interest rate which has been rising continuously in recent years. The ceiling on interest collected on credit¹³ granted in the course of 1977 varied mostly between 17 and 22 percent, depending on the location of the financed enterprise and the destination of its product. Another portion of the cheap credit to these sectors was unlinked and granted at an interest rate of 22 percent, following the directive of public bodies only authorized by the public sector ("complementary financing" to industry and financing of Hevrath Haovdim, according to a special arrangement with the government). The repayment period generally extends between 5 and 8 years in industry and 17 years or more in agriculture.

Directed mortgage credit to tenants, and a great portion of "other credit" to households, was also granted unlinked and at varying interest rates, ranging between 2 and 29 percent, depending on the area, the priority group to which the tenant belongs, and the price of the flat. The growth trend in the average interest rate for this type of credit continued in the last three years as well¹⁴. Additionally, part of the mortgage credit for private housing (with restrictions connected with the price of the flat) is also granted unlinked at the expense of the public sector, but bears a relatively high nominal interest that has increased a number of times in the course of the period. At the beginning of 1978, this interest rate varied between 26 and 32 percent, depending on the price of the purchased flat. Most of the credit for private housing granted this year was provided under these terms. The period of repayment for some types of directed mortgage credit was abbreviated this year, from 20 to 12 years.

¹⁴ For details of the arrangements, see below.

In 1977 the growth trend in interest rates on directed credit to economic sectors and households persisted, but this year's accelerated rate of price increase raised the inherent subsidy on the balance of unpaid credit from previous years. Despite the increased interest rates on credit pursuant to new authorizations, the interest rate still comprises a substantial subsidy. However, in view of the fact that this is long-term credit, a drop in the rate of inflation will translate into a drastically reduced subsidy, and interest on a portion of mortgage credit might approach very high real rates. A different method for determining interest, and in particular one that tied interest rates to the pace of price increases, could have maintained a constant and predicted volume of subsidy even in years with varying inflation rates.

B. THE VOLUME OF CREDIT GRANTED

In 1977 the volume of gross medium and long-term credit granted by the system (to households, economic sectors and local authorities) increased by about 40 percent, and amounted to IL 12 980 million, as opposed to increases of 36 percent in 1976 and 44 percent in 1975. In real terms, this was the first year since 1974 when credit granted to households, and primarily mortgage credit, increased. This fact is to a large degree connected with the recovery that took place towards the end of the year in the construction branch. A substantial real increase, stemming mostly from increased investments by the Electric Company, took place in credit to services. Credit to industry also rose in real terms, albeit at a pace below last year's, while credit to agriculture and to local authorities decreases in real terms.

The real decline in credit granted by the system to local authorities, despite a context of stability in investments by these authorities, is connected with two institutional changes that took place this year. These caused the transfer of a considerable portion of the financing received by the authorities from institutions in the system to the commercial banks and to the Treasury. These changes are in turn tied to the development of linked long-term deposits in the commercial banking system. These deposits are utilized to grant credit to the government and to local authorities and are not included in credit presented in this chapter. Furthermore, during the latter half of the year, the State Lottery changed the channels of financial mediation through which it used to supply credit to local authorities, and transferred its deposits from the banking system to the Accountant General of the Treasury.

As a result of these developments there was a change this year in the breakdown according to destination of financing granted through the system. The proportion of credit to economic sectors in overall credit increased from 55 percent last year to 62 percent this year, while the proportion of credit to households decreased (from 32 percent to about

28 percent), despite the real increase in the volume of mortgage credit. About half of the decline in the share of credit to households can be ascribed to a considerable real growth (about 41 percent) in credit to the service sector. The other half derives from considerable fluctuation in the relatively prices of investments in the economic sectors: as a result of the slow increase in housing prices, there was a decrease in the relative share of credit earmarked for this purpose, despite the increase of its real volume.

C. CREDIT TO HOUSEHOLDS

In 1977 total credit to households increased by about 23 percent, a rate similar to that for the previous two years. Nominal growth rates are misleading, and the real picture is totally different.

The main component of credit to households – mortgage credit – increased this year by about 13 percent, a rate similar to 1976 and below the 28 percent rate set in 1975. However, in real terms there was an increase this year of about 5 percent, as compared with a real increase of about 1 percent in 1976, and a decline of 1 percent in 1975. 1977 is the second consecutive year in which credit to private housing increased significantly, although the intensity of this increase was smaller than last year. The proportion of credit for private housing in total mortgage credit amounted to about 25 percent, as against 22 and 14 percent in 1976 and 1975 respectively. In the course of the year, the sale of privately built flats increased by 6 percent, and their prices increased by 7.5 percent, triggering an increased demand for credit for private housing. There are discernible differences in the development of credit supply between the first and second halves of the year: a sharp decrease in the purchase of publicly constructed flats at the beginning of 1977, together with the increased free resources of the credit banks, led to an expanded supply of credit for financing the purchase of private housing during the first half of the year. In the second half of 1977, the trend in the sale of flats in public construction reversed, and theoretically a reduced supply of credit for private housing was to be anticipated during this period. Yet developments proved different. Data on credit point to an increase (of about 57 percent) in credit for private housing in the second half of the year, while the increase in directed credit for housing was more moderate (about 18 percent). A possible explanation of this development is that financing lags behind real activity. In the first half of the year, contractors tended to offer more convenient payment dates. Credit to private housing was granted to flats whose prices did not exceed the ceiling, at an interest to the borrowers which varied in the first half of the year between 16 and 21 percent. Interest was raised to 18-29 percent during the second half of the year. At the beginning of 1978, interest was raised again, and today it amounts to 26-32 percent, depending on the price of the flat. The difference between this price and the cost of the resources is covered

mainly by the government¹⁵. Credit for the purchase of flats exceeding the price ceiling does not enjoy linkage insurance, and interest to the borrower on it may reach 40 percent. We have no quantitative data on the volume of this type of loans, although it increased considerably, despite the fact that its proportion of total mortgage credit is still low.

Directed credit to tenants also increased in the second half of 1977, with the housing market's recovery from the recession in general, and the recovery of flats sold by public construction companies in particular. This credit had decreased in the first half of the year, although data on credit do not fully express the effect of price increases and sales at the end of 1977, due to arrears in financing. Interest rates on directed credit vary, depending on the preferences of the public sector, the priority group of the tenant, the price of the flat, and the neighborhood. They range from an average interest rate of 2.8 percent in the most preferred group (families living 3 or more persons per room) to about 29 percent for young couples with a low priority in non-development areas, tenants of the Saving for Housing Scheme, etc. In some of the credit groups, interest rates escalate during the course of the repayment period, in order to divide the burden of payment more evenly over the entire period of repayment of the loan. In addition, the period of repayment was shortened from 20 to 12 years on some of the directed credit granted to tenants.

As in 1976, "other credit" to households increased rapidly this year, and its proportion in total credit to households increased by about 35 percent, as opposed to 30 and 22 percent in 1976 and 1975 respectively. Among the principal causes for this development is the fact that consumer prices increased this year at a much faster pace than housing prices. This credit comprises mostly credit to savers granted by social insurance funds and companies (partly linked, directly or indirectly), subsidized credit granted to immigrants, civil servants and students, credit granted by mortgage banks for structural improvements and for transfer from rental to purchase, as well as credit allocated for housing construction in kibbutzim. The increase in credit granted by social insuring funds¹⁶ this year deserves particular attention, as does the decrease of credit granted via the commercial banking system within the framework of deposits for the granting of loans.

¹⁵ In some of the cases, mortgage banks collect "securing fees" from contractors sending them clients, and these funds serve to cover part of the mentioned difference.

¹⁶ See explanation in Part II section 2 of this Chapter.

D. CREDIT TO INDUSTRY AND AGRICULTURE

Credit to industry increased in 1977 at a somewhat slower pace than last year. However, since the increase in the cost of investments for industry was more rapid this year than in 1976, the real growth in the volume of credit was much lower. It totalled about 6 percent as compared with 22 percent and about 25 percent for 1976 and 1975 respectively. Due to the sharp decline in the volume of investments this year (a drop of 17 percent as opposed to an 8 percent drop in 1976 and a 17 percent increase in 1975), there was a considerable increase in the rates of financing this year over last year. The rate rose from 60 percent to 75 percent, as compared with 44 percent for the two preceding years¹⁷.

Credit to industry is granted within two frameworks:

(1) The Law for the Encouragement of Capital Investment, and regulations and arrangements arising from it. This is a recognized framework for financing investment in the sector. The Law links the granting of credit for investment with the site of the financed enterprise and the destination of its product. On the average, the credit rate ranges between 40 and 45 percent of the investment. Within this framework higher rates of financing can also be obtained (up to 85 percent of the investment) by accepting credit from foreign credit lines. Interest rates within this framework are higher, averaging about 26 percent, and exploitation of this framework is not yet widespread.

(2) "Complementary financing" – an arrangement between the Treasury and representatives of the various industrial sectors (Hevrath Haovdim, private industry, the industry of kibbutzim), according to which the latter are entitled to credit beyond the criteria prescribed by the Law for the Encouragement of Capital Investments. Until 1975 this arrangement existed only with Hevrath Haovdim, and its volume amounted to only 3 percent of total investments in industry. However, in the last two years volume expanded considerably. In 1976, "complementary financing" financed about 12 percent of investments, in 1977, about 15 percent, and towards 1978 this form of financing increased by an additional 60 percent.

The expansion of the "complementary financing" arrangement can account for about two thirds of the increase in the rate of financing industrial investments in 1976 via credit from the system. This year the expansion accounts for only about one third of the increase in the rate of financing. Since formal rates of financing did not change this year, no es-

¹⁷This is in the form of credit only and excludes the grant bestowed for financing investments in industry which amounted this year to about IL 800 million. Financing from public resources, both as credit and as grants, amounted to more than 80 percent of total investments.

TABLE XIX-6

INDUSTRIAL INVESTMENT CREDIT, 1974-1977
(IL million)

Year	Gross medium- and long-term credit granted (1)	Industrial invest- ment, at current prices (2)	Ratio of credit to investment (1)/(2) = (3)
1974	940	2,180	43
1975	1,650	3,660 ^a	45 ^a
1976	2,510 ^a	4,210 ^a	60 ^a
1977	3,700	4,910	75

^a Revised data.

SOURCE: Column 1 – Table XIX-1; Column 2 – Chapter IX.

stantial change can be discerned in the area composition of financing; the utilization of foreign credit lines for financing is also apparently small. This does not explain the additional increase in the rates of financing. It is conceivable that it derives in part from the delay in credit approval¹⁸ with respect to the actual implementation date for the investment. This is likely given the background of a sharp deceleration in investments. It should also be pointed out that in the past two years estimates of investments in industry were possibly deflected downwards at a non-negligible rate. This is due to a method of estimation and debiting of assembly and installation prices of equipment that does not reflect reality¹⁹. Hence the rate of actual financing apparently did not increase to 75 per cent. Meanwhile, there was a considerable increase in the rate of financing in the last two years.

¹⁸ Particularly the approval of the financing of price increases and additions to projects approved in the past and already completed.

¹⁹ See Chapter IX.

TABLE XIX-7

AGRICULTURAL INVESTMENT CREDIT, 1974-1977
(IL million)

Year	Gross medium- and long-term credit granted	Agricultural investment, at current prices, excl. land reclamation, affor- estation and drainage	Ratio of credit to investment (1)/(2) = (3)
	(1)	(2)	(3)
1974	490	550	89
1975	630	900	70
1976	850	1,210 ^a	70
1977	1,150	1,490	77

^a Revised data.

SOURCE: Column 1 – Table XIX-1; Column 2 – Chapter IX.

Credit to agriculture granted by the institutional system of the capital market decreased this year in real terms by about 6 percent, due to the more severe drop of investments in agriculture (about 10 percent) for the first time in many years. The rate of financing investments in the sector increased to 77 percent, as opposed to 70 percent in 1977 and 1976. It should be emphasized that the financing of investments in agriculture is subject to considerable yearly rate fluctuations. It is possible that this phenomenon springs chiefly from offsetting changes in the volume of credit granted directly by the public sector.

The credit to agriculture discussed here is cheap credit granted by a small group of institutions which specialize in financing the agricultural sector according to the directives of the Ministry of Agriculture and the Jewish Agency. The criteria for the allocation of this credit guarantee the financing of up to 90 percent of the value of the investment in preferred investment activities. Owing to the complexity of the framework under which this credit is granted, it is conceivable that some investment programs actually benefit from a rate of financing which is higher than their allotment under the specified criteria. Yet it is also possible that some of the amounts granted to farmers as concentrated credit or

within other frameworks was originally allocated to finance other financial activities of agricultural farms (construction for non-agricultural purposes, the purchase of durables, etc.). Another possibility is that a portion of the credit was never intended for financing investments, but was to serve as working capital and/or for the consolidation of debts connected with previous investments of the sector.

The formal method for calculating interest rates on credit to industry is to start with a basic interest of 5 percent, to which half of the linkage differentials are added. However, the existence of a relatively low interest ceiling, ranging at the end of 1977 between 17 and 22 percent, disrupts the relation between the price of credit and the rate of price increases.

The subsidy inherent in credit to agriculture is higher than that implicit in credit to industry. Despite the fact that terms of interest are similar, the rates are lower in practice due to the length of the repayment period (generally 17 years in agriculture, as opposed to 5-8 years in industry).

E. CREDIT TO OTHER SECTORS OF THE ECONOMY

In contradistinction to the agricultural and industrial sector, the construction sector and part of the service sector are less dependent on the institutional system of the capital market. This situation stems to a great extent from the lower priority accorded these sectors by the directing authorities (excluding credit to electricity and to the tourist sector, particularly investment in hotels). As a result, these sectors finance their investments to a greater extent from their own resources, from the commercial banking system, or from abroad.

Gross medium and long-term credit to the construction sector increased by 28 percent in nominal terms, which translates into a slight real decrease. It should be recalled that this data do not include short-term credit granted through the system to the construction sector. This year this credit dropped sharply, partially reflecting the recovery of the construction sector from its crisis. The sector no longer has to finance a huge inventory of unsold flats. However the drop chiefly mirrors a change in the method of financing a considerable part of public construction²⁰.

²⁰ Public construction altered its means of financing formerly financed by short-term sources of mortgage banks (the "emissionary financing" arrangement). It is presently financed by advance payments from the public sector, which started ordering construction in advance instead of buying flats after construction was completed.

The great real increase in the volume of credit granted this year to the service sector (41 percent in 1977 as against 12 percent last year) is tied mainly to substantial investments in the Electric Company. These investments are concentrated more in some years than in others (a similar development took place in 1975, when credit to services increased by about 70 percent in real terms for a similar reason). Credit for financing investments in tourism and in hotels decreased this year in real terms by about 23 percent, similar to the rate of decrease of investment in hotels and accommodations.

In addition to medium and long-term credit, institutions of the system also had short-term uses, at a net volume of about IL 2 billion, as against more than IL 1 billion last year. The items contributing to this year's increase in this item are premiums to be collected by insurance companies, liquid assets in foreign currency of trust funds, and both current account deposits and fixed-term deposits of the institutional system of the capital market with the banking system.

II. COMPONENTS OF THE CAPITAL MARKET

1. SOCIAL INSURANCE FUNDS

A. THE STRUCTURE OF THE SECTOR AND THE CHARACTER OF ITS ACTIVITY

The social insurance funds sector encompasses 180 funds, dealing with the management of pension funds, provident and severance pay funds. Some of the funds, mainly pension funds connected with the Histadrut (Labor Federation), also deal with the management of additional social funds, such as mutual assistance, vacation, illness, etc. A number of funds also manage employees' study funds, but the proportion of social and study funds in the activities of the sector is negligible. The funds of the sector can be divided into three main categories:

1. The group of pension funds of the Histadrut, which concentrates most of the monies of the pension funds of the sector (more than 90 percent).
2. The group of social insurance funds managed by the banking system, which manages provident and severance pay funds. About 80 percent of the monies of the provident and severance pay funds of the sector are in the hands of these institutions.
3. The group of social insurance funds managed by companies and enterprises for their employees, dealing with each of the three fields of activity of the sector (pension, provident, and severance pay). The weight of these funds in pensions and compensation is low, but they manage almost 20 percent of the monies of the system's provident funds.

In recent years there has been a continuing trend in provident and severance pay funds of enterprises to merge with the general funds operating around commercial banks. This trend partially stems from the advantages possessed by a large fund in volume and professional proficiency. It is also partially connected with the desire of fund members to increase their direct control over amounts accumulated to their credit, while displacing Worker's Councils and the management of the enterprise.

The social insurance funds sector is a sector of primary financial intermediaries, i.e. it mobilizes its means from domestic savings (households and employers). It only allocates a small part of these means (as loans to members, to employers and to others), while transferring their bulk to intermediary financing institutions (through the acquisition of securities issued by these institutions), which transfer them in turn to the various economic sectors and to households. In Table XIX-8 it can be seen that the huge majority of resources at the disposal of the sector are savings funds, and about 85 percent of total resources are passed onto the other financial intermediaries (mainly financial institutions). These savings are partly defined as the worker's deduction, and partly as the employer's allocation, but in fact the employer's allocation can also be considered as household savings, if social payments are also included in the definition of wages.

The law, as well as regulations in force, accord distinct priority to saving through social insurance funds over other types of current financial saving. This preference is expressed by tax reductions on current payments to social insurance funds, by the guarantee of high return rates on the investment of monies of the funds, and tax exemption on members' profits from their savings in this framework. The logic behind these arrangements is to encourage long-term contractual saving which will provide adequate income to households upon retirement from work (on reductions and benefits with respect to payments to social insurance funds see footnote 21).

Alongside regulations defining the terms of saving through social insurance funds, there exist regulations which dictate to these funds the methods for investing their means. These regulations have two main purposes: the first is to guarantee savings by directing them to "solid" financial investments providing an adequate real return, thus preventing mismanagement to the disadvantage of members of the fund. The second is to ensure that most of the financial resources mobilized by the social insurance funds serve for financing and for needs deemed vital by the public sector.

These regulations compelled the social insurance funds in 1977 to invest 92 percent (as against 89 percent last year) of the assets that have not been revalued in index-linked bonds. The fund can choose from a long list of issues defined by the public sector as approved investments for the purpose of these regulations. These bonds are issued for 17

years, and bear interest rate of 5.5 percent to pension funds and 5 percent to provident and compensation funds.

Since the terms of these bonds are more favorable than the terms of bonds issued to the public at large, the funds are forbidden to trade them without special permission.

B. MOBILIZATION OF FINANCIAL RESOURCES AND THEIR ALLOCATION²¹

In 1977, savings in social insurance funds accumulated at a very rapid rate, and accumulations increased by 32 percent in real terms, as against a decrease of 5 percent last year and 17 percent in 1975. This substantially increased accumulation stemmed primarily from a considerable acceleration in the rate of growth for new deposits. It is also to a certain degree the product of a slight decline in the growth of withdrawals by members of the funds. Half of the acceleration in deposits can be attributed to wage increases, and the balance to adjustments in the financial asset portfolio of the public and the increased rate of private saving.

²¹ As a background to understanding the development of payments to social insurance funds, the main regulations referring to this matter are given below:

	1975/76,	1976/77,	1977/78
	(IL)		
The maximum amounts for deposits, deductions and credit for payments to social insurance funds for the calculation of income tax:			
a. 1. Maximum payment deductible by the self-employed from taxable annual income	3,500	3,850	5,600
2. Maximum payment deductible by an employee with no pension or provident arrangements with his employer from taxable annual income	2,500	2,750	4,000
3. In addition to item (1); (2), tax credit at a rate of 25 percent from taxable annual income	2,500	2,750	4,000
b. Ceiling on annual deposits benefiting from the age of the account in which it is deposited	9,600	12,000	12,000
c. Additional annual deposit, above b; benefiting from the age of the account after 3 years.	--	--	12,000

The acquisition of securities somewhat exceeded total accumulation this year. This development stemmed mainly from an increase in compulsory investment in bonds towards the end of last year, but one can logically assume that this was also connected to developments that took place this year on the Stock Market and in convertible bonds. This brought about increased purchases on this market by social insurance funds.

(1) RECEIPTS AND PAYMENTS

The acceleration in the rate of growth for deposits and accumulation is typical this year for all types of social insurance funds. It is most prominent, however, in provident funds which are mostly operated by banking concerns. These funds serve the public at large, as opposed to funds of enterprises, whose membership is determined by the number of employees in the enterprise, and whose volume of payments to the fund is dictated by wage agreements. Payments in provident funds increased by 74 percent as against 44 percent last year. Given the fact that withdrawals remained stable, net accumulation in provident funds increased by 78 percent in nominal terms and by 32 percent in real terms (see Table XIX-9). It appears that this development is the combined result of a number of factors. The rate of wage growth increased, while there was a halt to the trend of diminished private saving. The continued decline in the proportion of direct investment in bonds in the public's preferred asset portfolio, raising both ceilings on deposits and tax reductions to members of the funds, was also a contributing factor. The ceilings on permitted annual payments were raised this year to considerably higher rates than last year. This created the possibility of doubling the maximum deposit (provided that these deposits are frozen for three years and afterward receive the regular rights in relation to the age of the account; see footnote 22), and thus there was an increased transfer of money to provident funds. The rapid increase in wages, amounting this year to about 52 percent compared with 37 percent last year, also contributed to the speed-up in the rate of increased payments. It appears that about half of the acceleration in the rate of payments can be attributed to the wage increases, and the latter half to adjustments in the financial asset portfolio and to an increase in the rates of private saving.

As mentioned, the rate of payments to pension funds also accelerated, although the rate fell below that of provident funds. The rate rose to 45 percent this year, as opposed to only about 34 percent last year. This moderate development is tied to the fact that membership in pension funds and the amounts payable are determined by wage agreements and are not tractable to the desires of the members. Hence provident funds are not affected by changes in savings propensities or in preferences concerning alternative saving channels.

TABLE XIX-8
SOURCES AND USES OF SOCIAL INSURANCE FUNDS, 1975–1977
 (IL million)

Sources	1975	1976	1977	Uses	1975	1976	1977
Net savings deposits ^a	1,735	2,162	3,853	Net transfers ^b	1,625	1,948	3,675
				Medium- and long-term credit granted	306	356	659
				Short-term uses, net ^c	28	(-2)	(-15)
				Surplus of expenditure over income and net purchase of real assets	49	159	157
Repayment of medium- and long-term loans	253	310	678	Net change in cash balances and demand deposits	-20	11	55
Total sources	1,988	2,472	4,531	Total uses	1,988	2,472	4,531

^a Net of payments to members and assuming that contributions to severance pay schemes are treated as part of household savings.

^b Consists predominantly of net purchases of securities and the rest consists mainly of deposits in banking and financial institutions.

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

SOURCES: For 1975 and 1976 – estimates of the Research Department, Bank of Israel; for 1977 – calculations from Central Bureau of Statistics data.

At the enterprise level, there had previously been a certain degree of flexibility in influencing the volume of payments and accumulation. This process was retarded once the level of pension insurance was raised from basic to comprehensive pension; payments grew in the last two years at a rate similar to the growth of wages (excluding the public and community services sector, whose employees receive no pension insurance in the framework of the funds). Payments increased, as mentioned, by 45 and 34 percent in the years 1977 and 1976, while wage payments increased by 46 and 39 percent respectively.

The pace of growth for withdrawals is pretty much unaffected by considerations of preference between various financial assets. It is mainly a product of both developments in wages, which underpin the payment of pensions, as well as the age composition of fund members. The ratio of growth for payments to members decreased this year by 33 percent, as opposed to 45 percent in each of the two preceding years. The decrease is only slightly related to current payments to pensioners and stems chiefly from a decline in the amounts withdrawn by retiring members.

As a result of developments in the sphere of payments and withdrawals, net accumulation in pension funds increased at a rate similar to accumulation in provident funds (72 percent, as against 78 percent in nominal terms); however, in absolute terms net accumulation in pension funds amounted to only about 40 percent of the accumulation in provident funds.

Payments to severance pay funds by employers to cover their obligations towards their employees also displayed a marked recovery. In this field, a number of institutional changes have taken place in recent years, alternately aggravating and alleviating the restrictions on the use of these funds. This uncertainty had previously deterred employers from increasing payments to these funds. This year the situation seems to have clarified, thus renewing the readiness of employers to pay. The various wage agreements signed during the course of the year brought about retroactive wage payments and specific increases (in various sectors of the economy) in wages, which serve as a basis for pension and severance payments. This phenomenon compelled employers to pay relatively large amounts to the funds.

(2) THE USE OF RESOURCES

According to the directives of the Treasury, the acquisition of securities is the main investment channel of social insurance funds²². The purchase of securities was relatively high

²² The rate of compulsory investment in approved investment was increased at the end of 1976 from 89 percent of total assets to 92 percent, and the funds were obliged to invest all their current accumulation during the transition period in approved investments until the actual rate of investment reached the new level in all the asset portfolios.

TABLE XIX-9
FLOW OF SAVINGS, BY TYPE OF FUND, 1975-1977

	1975	1976	1977	Annual change		
				1975	1976	1977
	(IL million)			(percent)		
Deposits						
Pension ^a	1,438	1,924	2,792	39	34	45
Provident ^b	1,481	2,126	3,703	25	44	74
Severance pay ^c	213	248	289	11	16	57
Mixed and other ^d	107	107	389
Total	3,239	4,405	7,170	31	36	63
Rate of real change in deposits ^e				-6	4	21
Payments to members						
Pension	914	1,312	1,741	45	44	33
Provident	414	670	1,112	97	62	66
Severance pay	148	218	326	53	47	50
Mixed and other	28	43	138
Total	1,504	2,243	3,317	56	49	48
Rate of real change in withdrawals ^e				12	14	10
Net accumulation						
Pension	524	612	1,051	29	17	72
Provident	1,067	1,456	2,591	10	36	78
Severance pay	65	30	63	(-31)	(-54)	110
Mixed and other	79	64	148
Total	1,735	2,162	3,853	15	25	78
Rate of real change in net accumulation				-17	-5	32
Total wage payments in economy	25,130	34,350	52,170	41	37	52
Total wage payments in economy less public and community services	16,600	23,140	33,720	43	39	46

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

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

^c Bank-administered central pay funds and company Histadrut funds.

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

^e Adjusted to change in annual average of Consumer Price Index.

SOURCE: For 1975-1976 - Estimates of the Research Department, Bank of Israel, and for 1977 - calculations from Central Bureau of Statistics data.

this year, and the relative share of other uses was reduced, particularly those of net deposits in banking and financial institutions, credit to members, to employers and to others (see Tables XIX-8 and A-XIX-4). Total acquisition of securities, at source as well as on the secondary market, was somewhat higher this year than net deposits in savings. However, as a result of the considerable reduction in net deposits in banking and financial institutions (net withdrawal of about IL 400 million, as opposed to only about IL 100 million last year) total net transfer of resources amounted to about IL 3.1 billion, which represents 95 percent of total savings deposits. It appears that this development stemmed from two factors. The first was the requirement that the rate of investment in approved securities for all asset portfolios be increased to 92 percent from a rate of 89 percent in the past. The second factor was the boom that hit the stock and convertible bond market this year. Many social insurance funds exercised their right for advance allocation of part of the issue, expecting a high return on this investment²³. The demand for credit by fund members increased this year in view of the increased amounts accumulated in their accounts, as well as continuously rising interest rates on the capital market and on directed credit. On the other hand, given the increase in compulsory investments in approved investments, as well as the funds' policy to invest in securities in general and in stocks and convertible bonds in particular, the ability of the funds to supply credit was constricted. In response, most funds, particularly the pension funds, significantly reduced the periods of the loans. These developments are expressed by a considerable increase of credit and payment fees in the sector. New loans increased by 85 percent, while the amounts repaid increased by about 120 percent. But the proportion of loans granted by the funds to members and to others decreased from 4.7 percent at the end of 1976 to 3.5 percent at the end of 1977. It is reasonable to assume that the funds reduced loans to non-member in particular. This was expressed in the considerable increase of loan repayments, and particularly in the withdrawals of deposits from financial banks and other institutions (see Table AXIX-4).

²³ In most issues the 40 percent ceiling on early allocations to institutional buyers (including the various social insurance funds which this year purchased at source about IL 285 million worth of shares and convertible bonds, as opposed to IL 89 million last year) was exploited. The funds are permitted to hold up to 5 percent of their compulsory investments in stocks and convertible bonds. Previous investments in this channel have been small. In March 1978 the ceiling on investments in stocks and convertible bonds was raised to 10 percent, but it is possible that some of the funds had already exceeded the permitted 5 percent prior to that date.

TABLE XIX-10

BALANCE SHEET OF THE SOCIAL INSURANCE INSTITUTIONS, 1976-1977

	1976	1977	Share of item in total balance	
			1976	1977
	(IL million)		(percent)	
Assets				
Securities	36,350	60,750	92.5	94.5
Members' loans	1,020	1,270	2.6	2.0
Other deposits and loans	820	970	2.1	1.5
Fixed assets	240	290	0.6	0.5
Employers' debt	250	330	0.6	0.5
Assets subject to interest and linkage and other current assets	600	650	1.6	1.0
Total assets	39,280	64,260	100.0	100.0
Liabilities				
Pension fund	17,860	27,700	45.5	43.1
Provident fund (and advanced study schemes)	15,510	26,990	39.5	42.0
Severance pay fund	3,920	6,040	10.0	9.4
Social and mutual funds	600	680	1.5	1.1
Dues and reserve fund	50	130	0.1	0.2
Aid fund and profit balance	1,180	2,370	3.0	3.7
Current liabilities	160	350	0.4	0.5
Total liabilities	39,280	64,260	100.0	100.0

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

SOURCE: Central Bureau of Statistics.

C. THE CONSOLIDATED BALANCE SHEET OF SOCIAL INSURANCE FUNDS²⁴

The structure of the social insurance fund sector and the developments that took place in the course of the last year are reflected in the structure of the balance sheet of assets and liabilities of the sector. Securities constitute the sector's primary assets. Their share in the balance sheet increased in the course of the year from 92.5 percent to 94.5 percent as a result of the increase in compulsory investments, as well as additional investments in bonds, shares and convertible bonds²⁵. In parallel, the proportion of credit to members and to others decreased, a development that was inevitable given the increased rates of compulsory investments in securities. The total balance sheet, at reassessed values, amounted at the end of the year to IL 64 billion, an increase of 65 percent in nominal terms and 15 percent in real terms.

On the liabilities side, the altered contribution of the various social insurance funds to the accumulation of savings in the sector stands out. The share of provident funds in total liabilities reached 42 percent this year, as opposed to 39.5 percent last year, while the share of pension funds decreased from 45.5 percent last year to 43.1 percent this year. At the same time it is worth noting that these proportions do not express the relative influence of rights in pension and provident funds in total financial assets of households. This is due to the fact that the liability presented in the balance sheet as "pension fund" does not measure the entire actuarial liability of the funds with respect to the rights of their member.

2. INSURANCE COMPANIES

A. REVENUES AND PAYMENTS IN LIFE INSURANCE

Revenues from life insurance premiums increased this year at a rate of 47 percent as against 40 percent last year, and amounted to IL 1,340 million. In real terms, this year's increase amounted to 9.2 percent, as compared with a 6.6 percent increase for last year. The increase in the growth rate of revenues from premiums is caused by a jump in the

²⁴ It should be emphasized that in Table XIX-10 the classification is according to funds, while the classification in Table XIX-10 (on which the following discussion is based) is according to reserves.

²⁵ The compulsory investment in approved investments, which is, as mentioned, 92 percent of total assets, cannot be fully compared to the weight of securities in the balance sheet, the compulsory investment is defined at purchase values of securities, as against reassessed values, and the basis of calculations is also somewhat different.

TABLE XIX-11

**INCOME, OUTGO, AND ACCUMULATION OF LIFE INSURANCE
COMPANIES IN ISRAEL ^a, 1975-1977**
(IL million)

	1975	1976 ^b	1977
1. Income			
A. Premiums	649	910	1,341
B. Interest	154	225	286
Total	803	1,135	1,627
2. Outgo			
A. Benefits to policyholders	212	292	432
B. Agents commissions	91	132	186
C. Other operating expenses	87	130	196
D. Gross profit ^c	66	94	153
Total	456	648	967
3. Surplus of income over outgo [(1)-(2)]	347	487	660
4. Income from investment of life insurance funds	596	776	1,239
5. Accumulation	943	1,263	1,899

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

^b Revised data.

^c Including profits of reinsurers abroad.

SOURCE: Calculations of the Research Department, Bank of Israel, based on an earlier survey of the Central Bureau of Statistics, for 1977, and on "Survey of Insurance Business in Israel", Central Bureau of Statistics, for previous years.

total growth of index-linked insurance (which combines a risk and savings component) and a decline in the growth rate of revenues from premiums on unlinked life insurance (mostly including risk insurance only, and expressing mainly group insurance and not that of individuals).

Savings undertaken via insurance companies are the least liquid framework within the range of financial saving channels and provide no suitable compensation in the form of return. Today, the insured individual cannot purchase linked life insurance without a saving component. It can be assumed that without this proviso the amount of saving through life insurance would have dropped drastically, or the return on this type of saving would have increased significantly.

Interest revenue and capital profits from investments in life insurance funds increased in 1977 by 52 percent, as compared with 33 percent last year. Most of this increase derives from the rapid growth of the life insurance fund in recent years, and only a small portion derives from the jump in the inflation rate²⁶.

Payment on claims by the insured increased this year by about 48 percent, as compared with 38 percent last year. This increase can be only partially ascribed to a growth in the inflation rate, and is based mainly on other variables, such as the growth in the size of policies, changes in pending claims, etc.

This year surplus of revenue from premiums over the various payments amounted to about IL 310 million, as opposed to IL 260 million last year. This represents an increase of 42 percent. Together with accumulated interest and linkage differentials, the "accumulation of the insured" increased this year by about IL 1.9 billion, as compared with IL 1.3 billion last year.

B. REVENUES AND PAYMENTS IN GENERAL INSURANCE

Revenues from general insurance premiums increased by 45 percent in 1977 as it did last year, and reached a volume of about IL 3.5 billion. Contrary to last year, and to a certain extent as a product of developments occurring last year, the growth of premiums declined considerably in automotive insurance (despite the fact that the number of vehicles grew at a slightly increased pace). Premiums in other branches of general insurance grew at a much more rapid rate (see Table XIX-12). It should be recalled that the considerable

²⁶ From end of June to end of June, the relevant "year" for the reassessment of life insurance funds, inflation this year reached about 33 percent, as opposed to only about 30 percent last year.

TABLE XIX-12

GENERAL INSURANCE PREMIUM RECEIPTS^a, 1975-1977

	1975	1976 ^b	1977
	(IL million)		
Total general premium receipts ^c	1,676	2,437	3,524
Motor vehicle insurance	(653)	(1,034)	(1,416)
Other insurance	(1,023)	(1,403)	(2,108)
Annual increase in premium receipts	(percent)		
Total general insurance	42.6	45.4	44.6
Motor vehicle insurance	(44.8)	(58.4)	(36.9)
Other insurance	(41.3)	(37.2)	(50.3)

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

b. Revised data.

c. Including income from premiums, registration fees, policy fees, collection fees and other payments collected from policy holders, including maritime insurance and deducting reinsurance in Israel and raised interest.

SOURCE: Calculations of the Research Department, Bank of Israel, based on an earlier survey of the Central Bureau of Statistics, for 1977, and on "Survey of Insurance Business in Israel", Central Bureau of Statistics, for previous years.

growth last year in premium revenues from automotive insurance was rooted in the introduction of a new road-accident insurance law. The new law raised the total amount of premium payments. Although this law continued to be enforced this year as well, the growth of revenues from premiums slackened after total revenues had attained the new level required by the law. In other insurance branches premiums grew at an accelerated rate, due to a jump in the pace of price increases. Raw material and product inventories (including diamonds) held by various business also grew, as compared to the decrease that took place last year. Most of the premiums in general insurance are transfer payments, but a small portion is accumulated and constitutes a contribution to saving in the economy. It is expressed by accumulation in the general fund and partially in the item of pending and approved claims. This accumulation is utilized to grant credit and purchase bonds on the free market.

C. ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES

The balance of Israeli insurance companies increased this year by 50 percent, compared with 58 percent last year, and reached a volume of about IL 11.2 billion. Since not all the items on the balance sheet are reassessed according to the same price index, and this year the accounting principles which govern the preparation of the insurance companies' balance sheets have been altered (they include part of the previous accumulation of linkage differentials)²⁷, the rate of real growth cannot be calculated exactly. Yet, since all price indices used in the reassessment are higher this year than last year, and in view of the above-mentioned change in accounting principles, it appears that the decline in the pace of real growth of the balance sheet is greater than what appears from its nominal rate of growth.

As a result of the above-mentioned limitations on the data, it is impossible to analyze precisely the significance of the change in the various items, and particularly those containing linkage differentials. Yet it is worth emphasizing the relatively low rate of growth in other loans, which are mostly unlinked commercial loans. These grew by 21 percent this year as against 91 percent last year, and in contrast to the rapid increase in the balance of premiums to be collected: 63 percent this year as against only 38 percent last year. It appears that as part of the competition between insurance companies, the period of free credit granted by them at the expense of granting loans on commercial terms has been extended. It is unclear whether the insured or the insurance agent benefitted most from the increase in premiums to be collected.

Within the framework of this year's boom in new issues of shares and convertible bonds, the insurance companies mobilized IL 200 million in this manner, as against only IL 20 million last year. This fact contributed to the increase in the equity capital component from 1.7 percent of the total amount of the balance sheet last year to 8.9 percent of the balance sheet this year.

²⁷ This year most of the insurance companies present all accumulated linkage differentials on investments with respect to the general insurance fund and unlinked life insurance that have previously been unrecorded in the balance sheet. Henceforth, all linkage differentials in these funds will be recorded currently, as in linked life insurance. The reassessment of balance sheet items connected with linked life insurance is predicated upon the increase of the index from June to June, while the reassessment of other linked items in the balance sheet is based on the final index prior to the closure of the balance sheet, i.e. according to the index for November.

TABLE XIX-13

ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES, 1975-1977

	1975	1976 ^a	1977	1975	1976 ^a	1977
	(IL million)			(percent)		
Assets						
Government or government guaranteed bonds	2,600	3,951	6,658	55.0	53.0	59.5
Other securities	84	120	218	1.8	1.6	2.0
Loans on policies	49	69	125	1.0	0.9	1.1
Other loans	560	1,068	1,289	11.9	14.3	11.5
Long-term deposits	73	104	233	1.5	1.4	2.1
Real estate and investment in subsidiaries	181	225	272	3.8	3.0	2.4
Outstanding premiums	455	629	1,026	9.6	8.4	9.2
Sundry debtors	360	718	776	7.7	9.6	6.9
Cash and demand deposits	361	574	590	7.7	7.8	5.3
Total assets	4,723	7,458	11,187	100.0	100.0	100.0
Liabilities						
Paid-up share capital	166	227	322	3.5	3.0	2.9
General and other reserves	213	308	666	4.5	4.1	6.0
Life insurance reserve (less reinsurance)	2,335	3,545	5,296	49.4	47.5	47.3
General insurance reserve (less reinsurance)	370	676	925	7.8	9.1	8.3
Extraordinary risks reserve	155	231	307	3.3	3.1	2.7
Deposits of reinsurers	274	350	404	5.8	4.7	3.6
Pending and approved claims	823	1,305	2,204	17.4	17.5	19.7
Current liabilities	387	816	1,063	8.3	11.0	9.5
Total liabilities	4,723	7,458	11,187	100.0	100.0	100.0

^a Revised data.

SOURCE: Calculations of the Research Department, Bank of Israel, based on an earlier survey by the Central Bureau of Statistics, for 1977, and on "Survey of Insurance Business in Israel", Central Bureau of Statistics, for previous years.