

## CHAPTER XIII

# MONEY SUPPLY, CREDIT, AND THE BANKING INSTITUTIONS

### 1. MAIN DEVELOPMENTS

IN ANALYZING monetary developments in 1973 and their influence on economic activity three subperiods can be distinguished. In the first, from January through March, the money supply held steady, while between April and September it rose by an average of 3 percent a month. Nevertheless, over the first nine months as a whole the rate of monetary expansion was lower than in the corresponding period the year before, when demand pressure was very strong. The third subperiod dates from the outbreak of the October war (and carried over through the first quarter of 1974), during which a reflationary monetary policy was followed in order to prevent the disruption of economic activity because of the emergency situation.

Various developments in the economy during the first nine months of 1973 indicate the existence of strong demand pressure, reflected by the acceleration of inflation, a steep rise in the balance of payments deficit on current account, and a further drop in unemployment. There is no evidence that during this period monetary developments effectively dampened the mounting demand pressure, which emanated largely from the household and public sectors, although the monetary indicators do point to some deceleration.

Table XIII-1 shows that the money base broadly defined—currency in circulation and liquid assets of the banks (including credits granted within the framework of liquidity exemptions)—expanded during the first three quarters of 1973 by 16 percent, compared with 27 percent in the same period in 1972, while the money supply grew by 20 as against 23 percent. Unlinked interest-bearing assets—time deposits in local currency and the Short-Term Loan—did not increase during this period, whereas during the first nine months of 1972 they had expanded by an appreciable 19 percent.

Financial assets moving up at a faster rate during the first nine months of 1973 were linked saving schemes and bonds—to which part of the liquidity previously held in the form of unlinked assets was shifted—and foreign currency deposits of the public, which expanded mainly because of the appreciation of the German mark.

A comparison of the growth of the economy's transactions during the first nine months of 1973 with the rise in the average monthly balance of unlinked

liquid assets of the public (the money supply, IL time deposits, and the Short-Term Loan) shows a sluggish monetary expansion and a much faster circulation velocity of the money supply, defined both narrowly ( $M_1$ ) and broadly ( $M_2$ —i.e. total unlinked liquid assets). Whereas resource uses (excluding imports of ships and aircraft and direct defense imports) shot up 34 percent during the period discussed as compared with the same period in 1972 and GNP expanded by 29 percent, the average monthly balance of the money supply narrowly defined went up 23 percent and broadly defined by 18 percent.<sup>1</sup>

The sharpening of the inflation during the first three quarters of 1973 despite the slower expansion of the money base, money supply, and unlinked liquid assets can be attributed to several factors:

(a) The swelling of the money base and the money supply in 1971 and 1972 was not fully reflected in the commodity and service markets in those years, and in 1972 considerable liquidity was tied down in existing assets such as real estate and shares. It is reasonable to assume that during the first nine months of 1973 there was some slackening in the volume of transactions in these markets, with the funds released thereby providing the liquidity required for the larger volume of transactions in the commodity and service markets.

(b) The aggravation of inflation generally dampens the demand for holding unlinked assets, so that a given increase in economic activity can be financed by a smaller growth of liquid asset holdings (a development reflected by a rise in the rate of turnover). The intensification of inflation during the first nine months of 1973 greatly affected the demand for time deposits and the Short-Term Loan.

(c) There is evidence that the above measures of the public's liquidity were downward-biased in 1973, as it held part of its liquidity in the form of value-linked bonds. This change in the role of part of the stock of linked bonds from a savings medium to a substitute for time deposits, the Short-Term Loan, and perhaps also demand deposits was connected with the acceleration of inflation in the fourth quarter of 1972, which drove up nominal bond yields while diminishing the risk of holding such paper for short periods (explained in section 2 below).

In other words, despite the slackening of monetary expansion during the first three quarters of 1973, which in itself should have led to a considerable tightening of the money market and prevented the generation of the demand pressures which existed during this period, the above three factors explain

<sup>1</sup> The growth of the average monthly balance of the money supply during the first nine months of 1973 (compared with the same period the year before) exceeded that in the money supply between December 1972 and September 1973, since the average monthly balance was influenced by the rapid rise in the second half of 1972.

**Table XIII-1**  
**ANNUAL CHANGES IN MAJOR MONETARY AGGREGATES, 1971-73**  
(IL million)

Year	Balance at end of year	Change in end-year balance		Annual average balance	Change in annual average balance	
		IL m.	%		IL m.	%
<b>Money supply</b>						
1971	4,341	956	28.2	3,876	709	22.4
1972						
Jan.-Sept.		978	22.5	4,899		
Oct.-Dec.		268	5.0			
Entire year	5,587	1,246	28.7	5,041	1,165	30.1
1973						
Jan.-Sept.		1,108	19.8	6,005		22.6 <sup>a</sup>
Oct.-Dec.		697	10.4			
Entire year	7,392	1,805	32.3	6,315	1,274	25.3
<b>Unlinked liquid assets of the public<sup>b</sup></b>						
1971	7,877	1,807	29.8	7,061	1,492	26.8
1972						
Jan.-Sept.		1,656	21.0	8,799		
Oct.-Dec.		516	5.1			
Entire year						
Original series	10,049	2,172	27.6	9,073	2,012	28.5
New series <sup>c</sup>	10,172					
1973						
Jan.-Sept.		1,014	10.0	10,373		17.9 <sup>a</sup>
Oct.-Dec.		433	3.9			
Entire year	11,619	1,447	14.2	10,626	1,553	17.1
<b>Money base (broadly defined)<sup>d</sup></b>						
1971	4,175	1,259	43.2	3,546	863	32.2
1972						
Jan.-Sept.		1,128	27.0	4,828		
Oct.-Dec.		179	3.4			
Entire year	5,484	1,309	31.4	4,972	1,426	40.2
1973						
Jan.-Sept.		880	16.0	5,772		19.6 <sup>a</sup>
Oct.-Dec.		569	8.9			
Entire year	6,936	1,452	26.5	5,989	1,017	20.5

<sup>a</sup> Average monthly balance in January-September, 1973 compared with the same period in 1972.

<sup>b</sup> Money supply, time deposits in Israeli currency, and Short-Term Loan.

<sup>c</sup> In 1972 the form of bank reporting was revised, with the result that several definitions were changed.

<sup>d</sup> Currency in circulation, the banking institutions' liquid assets, and exemptions from the liquidity requirements (including authorized liquidity deficits).

why there was such a steep rise in prices and the import surplus during this period.

The liquidity deficiencies incurred by the banks, the raising of debitory interest rates, and the attempt by the banks to check the expansion of credit indicate that there was in fact a change in the economy's liquidity situation—a move from the relative abundance which marked the year 1972 (until November) to a fairly tight money market during the first nine months of 1973. However, as already noted, this failed to prevent negative price and balance of payments developments, for monetary policy was not sufficiently supported by proper fiscal and incomes policies.

The main cause of the slower monetary expansion during the first nine months of 1973 was the much smaller liquidity infusion, a result of the contraction of foreign currency sales by the private sector from IL 2,050 million in the first nine months of 1972 to IL 1,200 million in the comparable period in the year reviewed. The latter was connected with the widening of the adverse balance on goods and services account without any concomitant increase in the private sector's capital import. During the first nine months of 1972 part of the liquidity infusion engendered by balance of payments developments was offset by the absorption of IL 325 million by the Government, whereas during the same period in 1973 the Government's operations had a neutral effect (the first-quarter absorption was followed by the injection of a similar amount in the second and third quarters).

The absorptive measures pursued by the Bank of Israel consisted of the sale of the Short-Term Loan, the hiking of liquidity ratios on time deposits by 2 percentage points, and the raising of the commercial banks' participation in the various export finance funds—these mopped up some IL 270 million by September. In mid-July the Bank also slapped a 100 percent liquidity ratio on incremental nondirected credit granted from the banks' free reserves, a step whose main effect (until it was lifted in October) was to retard the growth of credit and to reduce the banks' liquidity deficiencies. The amount of liquidity drawn out of the economy by these measures was much smaller than in the same period the year before. It is important to note that the change in the composition of monetary expansion (discussed below) greatly reduced the sources for expanding bank credit, and the absorptive monetary policy pursued during the first nine months of 1973 met with stronger public opposition than in the past.

Because of the rampant inflation and the negative real rates of interest even on nondirected bank credit, there was a livelier demand for such finance during the period reviewed, and its expansion was a weightier factor in total monetary expansion than in the past. Nevertheless, it must be stressed that its growth was entirely concentrated in the first quarter of the year, whereas between April and September the level held steady. In stepping up its lending operations during the first nine months of 1973 the banks incurred liquidity

deficiencies throughout the entire period, but since April they have taken action, with varying degrees of success, to reduce them.

The composition of the monetary expansion during this period was also influenced by the inflationary expectations and the mounting demand for linked assets. This is indicated by the arresting of the uptrend in time deposits and the Short-Term Loan, the rising share of currency in circulation in the money supply, and the swelling of linked saving scheme deposits, which began even before the introduction of a new, especially attractive plan. This period also saw an enormous growth in linked bond holdings and the public's foreign currency deposits. This meant that the banks were not left with any sizable sources of loanable funds, for the reversal of the rising trend in time deposits deprived them of their principal source for expanding credit from own means. However, the banks issued IL 350 million worth of shares and convertible bonds both through and outside the Stock Exchange, thereby procuring additional loanable funds.

From the outbreak of the war until the beginning of the 1974/75 fiscal year the Treasury and the Bank of Israel followed an expansionary monetary policy designed to supply all the liquidity needed to tide the economy over during the emergency period. The purpose of this policy was to prevent the interruption of production and marketing expected in the wake of the extensive mobilization of manpower and equipment and the slump in sales, which persisted until the beginning of 1974. With the release of reservists and civilian equipment that had been mobilized, the need arose to assure their reemployment, which was liable to be affected by the mood of uncertainty prevailing at the time, and this necessitated an ample supply of liquidity.

Data on the performance of the various economic sectors during the period up to the disengagement of forces and immediately thereafter indicate that the restoration of normal economic activity was not hampered by any shortage of liquidity, and in this sense the monetary policy achieved its objective. However, part of the abundant liquidity infused into the economy was used to finance speculative foreign currency transactions and purchases of linked bonds. Expectations of a devaluation of the IL and of the further spiralling of prices began to sharpen in mid-November, leading to a heavier purchase of foreign currency by businesses and others, who hastened to pay off foreign liabilities and held up the transfer of foreign currency from abroad. This was made possible by the abundant supply of bank credit. The record volume of linked bond purchases was financed predominantly by the shift away from Short-Term Loan and unlinked deposit holdings of the public, but it is a reasonable assumption that some of the purchases were financed directly or indirectly through bank credit. This was especially true in January, when the public began to anticipate a decline in the return on new issues.

While the bond purchases yielded some of the buyers a very handsome profit, the speculative purchases of foreign currency had a damaging effect

on the country's foreign exchange reserves. But the most negative impact was associated with the liquidity deficiencies incurred by the banking institutions, as a result of which the Bank of Israel and the Treasury began to pump liquidity into the economy. Coming after the deliberate monetary expansion in the last quarter of the year, this led to a renewed buildup of the economy's liquidity reserves.

To recapitulate, during the first nine months of 1973 the economy was marked by demand inflation, which the monetary measures adopted failed to adequately harness. The excess liquidity existing at the end of 1972 was probably absorbed during this period, and there may even have been some squeeze on the public's liquid balances.

From October 1973 until the beginning of the 1974/75 fiscal year an expansionary monetary policy was followed, which resulted in the renewed buildup of excess liquidity in the economy. This of course has very significant implications, and calls for an energetic absorptive monetary policy for the year 1974/75.

It must be stressed that the foregoing assumes that the public regards part of its stock of linked bonds as a liquid asset. If this is indeed so, then the conventional measures of liquidity are understated: they indicate a sharp decline in the money base and the money supply in the first quarter of 1974, but there did not seem to be any shortage of liquidity in the economy.

However, the reshuffling of the economy's portfolio of liquid assets has several important implications which transcend what has been stated above. First of all, it may be assumed that were it not for the switch to linked bonds, demand pressure in the real estate, commodity, and service markets would have been greater still. Part of the demand for money and unlinked liquid assets shifted to linked bonds, and had this instrument not been available for preserving the purchasing power of the public's liquid assets, there would have been an intensification of pressure in the real markets.

Secondly, the increase in the share of linked bonds and the decline in that of unlinked assets weakened the real-balance effect, which plays an important role in absorbing excess demand through price rises. Since 1962 the linkage of mortgage and development loans has been gradually eliminated, while the issue of linked bonds to the public and financial institutions has continued. This has appreciated the wealth of borrowers in periods of rising prices, without depreciating the value of savings in the economy, the gap between the two being covered by the Government budget.<sup>2</sup>

The only component of the public's net financial assets (assets minus liabilities) that is not linked is the money base, and the erosion of its real value

<sup>2</sup> In addition to the above there are several other effects on the Government budget, such as the weakening of the absorptive impact of indirect taxation and some loss of flexibility in budget planning.

because of accelerating inflation blunted the wealth effect induced by the existence of linked assets. But as long as bonds take the place of money and other unlinked assets, this will tend to dampen the growth of the money base and further weaken the real-balance effect.

In an economy with a capital market like Israel's one may therefore expect that, in the absence of a stringent fiscal policy, excess demand will be siphoned off mainly through an increase in the balance of payments deficit, for the contractionary effect of rising prices on the public's purchasing power tends to diminish steadily.

Another conceptual change necessitated by the acceleration of inflation and the switch to linked bonds as a substitute for unlinked liquid assets is connected with the meaningfulness of the conventional definition of Government absorption. It is doubtful whether all the Government's proceeds from bond sales to the public (either directly or through financial institutions) can be regarded as a liquidity absorption, for the mobilization of funds which creates liquid assets is not usually regarded as an absorptive measure.<sup>3</sup>

Another aspect of the points discussed above is the dwindling of the banks' loanable funds because of the contraction of IL time deposits and the switch to linked bonds. This results in large liquidity deficiencies and forces the banks to take action to check the growth of credit and perhaps even to reduce it in absolute terms. In a period of strong credit demand—for both ordinary requirements and because of inflationary expectations—it is only natural that pressure is brought to bear on the central bank to inject liquidity into the economy so as to ease the credit squeeze, even though the amount of effective liquidity is much higher than what the conventional indicators show.

Finally, it should be stressed that the implications of the doubling and tripling of the rate of inflation in the past two years have not yet been adequately studied. The inflation has reached virtually unprecedented dimensions, and it is therefore impossible to rely on past experience or that of other economies which do not have value-linkage arrangements as in Israel.

## 2. THE INFLUENCE OF MONETARY DEVELOPMENTS ON THE ECONOMY

### (a) *January to September*

Monetary expansion in the first nine months of 1973 was much slower than in the same period the year before. The money base increased by 16 percent as against 27 percent in 1972, and the money supply by 19.8 vs. 22.5 percent; other unlinked liquid assets of the public—time deposits and the Short-Term

<sup>3</sup> This applies to only part of the funds raised in the capital market. The high inflation did not affect the absorptive character of bonds purchased by social insurance funds and approved saving schemes, since these two savings instruments continued to be fairly illiquid (in 1973 the liquidity of the approved saving scheme funds was even reduced considerably).

Loan—declined 2 percent, after rising 18.7 percent in the previous year. The money supply and unlinked liquid assets combined grew by only 10 percent, after a 21 percent advance in the first nine months of 1972.

The movement of these monetary aggregates in the first three quarters of 1973 appears sluggish not only in comparison with the same period the year before but also compared with the expansion of real economic activity and with the exogenous price rises due to developments both abroad and in Israel. Nevertheless, there were strong demand pressures in the period under review, reflected by the soaring of prices well in excess of what can be attributed to the exogenous factors, by a jump in the balance of payments deficit on current account, and by an extremely low unemployment rate.

The acceleration of inflation despite the more sluggish monetary expansion requires clarification.

First of all, the above-mentioned indicators slightly overstate the actual deceleration in liquidity in the first nine months of 1973 as measured by the average monthly balance of the public's liquid asset holdings. The rapid growth of the money supply and unlinked interest-bearing assets in 1972 pushed up their average monthly level in 1973, despite the marked slackening of the uptrend. The average monthly level of the money supply stood 22.6 percent higher than in the first three quarters of 1972, while interest-bearing assets rose by 12 percent; the combined increase was 17.9 percent.

But even after allowing for the change in the average monthly balance of the public's unlinked liquid assets, nominal economic activity far outstripped the growth of the money supply, whether broadly or narrowly defined: during the first nine months of 1973 domestic resource uses rose 33.8 percent above their level in the comparable period the year before, and the gross national product by 29.2 percent. As a result, the velocity of circulation of the money supply rose to its highest level since the economy emerged from the recession of 1966-67 (see Table XIII-3).<sup>4</sup>

Examination of the development of these two types of liquid assets raises the question: how is it that strong demand pressure arose in 1973, leading to a sharp increase in prices and a much bigger import surplus without a concomitant growth of the public's liquid asset balances? Part of the liquidity required for financing economic activity in 1973 came from the public's incremental liquid asset holdings. In addition, there were two conventional sources of liquidity, one of which increased its supply while the other dampened the demand for it.

The stronger demand for liquidity in 1973 was induced by the increase in consumption—the marked acceleration of private consumption and a rise

<sup>4</sup> The circulation velocity of the money supply declined according to both definitions of the latter: the narrow definition of currency and demand deposits, and the broader definition, which also includes time deposits and the Short-Term-Loan.

Table XIII-2  
INDICATORS OF THE TURNOVER VELOCITY OF LIQUID ASSETS HELD  
BY THE PUBLIC, 1970-73

	Average velocity of demand deposits <sup>a</sup>	Annual average velocity relative to GNP <sup>b</sup>	
		Money supply (M <sub>1</sub> )	Money supply and unlinked liquid assets <sup>c</sup> (M <sub>2</sub> )
1970	21.5	5.85	3.35
1971	23.0	6.00	3.29
1972			
Jan.-Sept.	24.4	5.78	3.22
Entire year	24.5	5.79	3.21
1973			
Jan.-Sept.	26.2	6.09	3.52
<b>Annual average velocity relative to the economy's resource uses<sup>d</sup></b>			
1970		8.40	4.78
1971		8.75	4.80
1972			
Jan.-Sept.		8.50	4.73
Entire year		8.55	4.75
1973			
Jan.-Sept.		9.28	5.37

<sup>a</sup> Total debits to local-currency demand deposits in banks, divided by the annual average volume of these deposits.

<sup>b</sup> The gross national product at current prices (based on the effective exchange rate), divided by the annual average volume of the two aggregates.

<sup>c</sup> This is the first time that the velocity of circulation of M<sub>2</sub> (the money supply, IL time deposits, and the Short-Term Loan) has been presented in the *Annual Report*.

<sup>d</sup> The gross national product at current prices, plus the import surplus net of ships and aircraft and direct defense imports (both GNP and the import surplus are based on the effective exchange rate), divided by the annual average volume of the two aggregates.

in public consumption (excluding direct defense imports) after a slight downturn in 1972 in real terms. On the other hand, other uses rose more slowly in the period reviewed.

As explained in Chapter IV, the acceleration of private consumption and the decline in the rate of private saving in 1973 were a lagged response to the sluggish growth of consumption in the preceding years, reinforced by mounting expectations of a further spiralling of prices. This development probably did not depend very much on the rate of monetary expansion during the first nine months of 1973; rather monetary developments accommodated themselves to the growth of consumption.

The additional consumption spending of the household sector was financed by disinvesting in financial assets, cutting down the purchase of homes,

borrowing from various sources, and perhaps also from the spare funds made available by the reduction of the real repayment burden of unlinked debts (such as mortgage loans, members' loans from social insurance funds, etc.). But from the macroeconomic aspect the expansion of economic activity attributable to consumption and other final demands entailed a larger increase in the money supply than actually took place.

Part of the additional funds required apparently originated in the liquidity surpluses created in 1972, when the inflationary effects of the rapid monetary expansion did not run their full course. The strong monetary expansion of 1971 and 1972 depressed the circulation velocity of the money supply (both narrowly and broadly defined). The buildup of excess liquidity in 1972 may be regarded as a lagged response of the goods and services markets to the monetary expansion of 1971-72, since the year 1972 witnessed an enormously larger volume of transactions in real estate, securities, and other assets, which tied down part of the incremental money supply.

The buoyancy of these markets was apparently one of the reasons for the better household saving performance in 1972. The change in this sector's behavior in the first nine months of 1973 was linked, as stated, to the accommodation of consumption to the growth of income and the expectation of a further appreciable jump in commodity and service prices, which was stimulated by the large capital gains earned by holders of the above-mentioned assets in 1972 and the propensity to consume part of these gains. (A similar development had taken place in 1962, when the devaluation of the IL was followed by a rapid expansion of the money supply.) It is therefore likely that funds which in 1972 were intended for investment in shares, real estate, and other assets were diverted to the goods and services markets in the year reviewed.

Share turnover on the Tel Aviv Stock Exchange during the first three quarters of 1973 reached IL 920 million, compared with IL 750 million in 1972, but the figure for the March-September period dipped from IL 616 million in 1972 to IL 511 million in the year reviewed. Trading volume reached its peak in January 1973 (as did the index of share prices), but in March it began to slip below its level in the previous year.

Another factor which helped to ward off a liquidity squeeze in the first nine months of 1973 was the easing of demand for unlinked liquid assets due to expectations of a further acceleration of inflation, which led to the shrinkage of time deposits and Short-Term Loan holdings in particular.

Studies conducted in other countries reveal that the sharpening of inflation dampens the desire to hold money (whether broadly or narrowly defined), and Israel is no exception in this respect. The acceleration of inflation increases the cost of holding money in terms of purchasing power, and accordingly induces a more economical use of this "commodity". In other words, the

expectation of a further strong price rise tends to speed up the circulation velocity of the money supply while reducing the quantity required for financing a given volume of transactions.<sup>5</sup>

Another indicator of the impact of mounting inflation on money balances is the rising share of currency in the money supply evident since the beginning of 1973 and which became more pronounced in the immediate postwar period (see section 4 below). But for the public's desire to shed part of its money holdings, the aggravation of inflation presumably would not have significantly altered the composition of the money supply. However, since the possibility of reducing cash holdings is relatively limited (in comparison with other unlinked assets), the diminished demand for liquidity mainly affected demand deposits and even unlinked interest-bearing assets. As will be explained below, part of the demand shifted to value-linked bonds, which in 1973 proved an attractive alternative to such deposits, and apparently also to consumer durable assets. This development has become more prominent since October 1973, but there is no doubt that the forces described were already operating at the beginning of the year, when inflationary expectations began to mount.

These expectations had a stronger impact on the demand for money in 1973 than in previous years, even though the advance of prices began to gather momentum as early as mid-1970. The rapid growth of unlinked interest-bearing assets in 1971, which slackened slightly in 1972 and was arrested only in 1973, suggests that the adaptation of the economy to the inflation, which has been going on since the start of the decade, has been a fairly protracted process, and it was only in 1973 that the flight from unlinked assets assumed striking proportions.

The utilization of the liquidity surpluses built up in previous years and the fading demand for unlinked liquid assets explain why the liquidity shortage in the first nine months of 1973 was not more acute. But while these developments partly blunted the effect of the rapid monetary expansion, a number of signs still pointed to a change in the liquidity situation during the first three quarters of 1973 as compared with 1972.

First, the banks were in a liquidity deficiency position during most of this period, whereas between January and November 1972 they ran liquidity surpluses (except for the usual April deficit). The growth of the deficiencies in 1973 followed the normal seasonal pattern: an increase from January to the end of March, followed by a gradual decline. However, even between June and September the average daily deficiency of the entire banking system amounted to more than 4 percent of the required liquid cover (see Table

<sup>5</sup> A study of the determinants of the demand for holding money conducted by the Bank of Israel Research Department points to such a connection. The quantitative impact of the acceleration of inflation on the demand for money is greater in the case of  $M_2$  (the money supply plus time deposits and the Short-Term Loan) than for  $M_1$  (see the discussion below).

XIII-6). These deficiencies entailed the payment of a 16 percent fine, which is not a deductible expense for tax purposes.<sup>6</sup>

Secondly, in order to reduce their liquidity deficiencies the banks took action during the first nine months of 1973 to cut down the supply of non-directed credit, first by raising the interest on unauthorized overdrafts and subsequently by upping debitory interest rates by one percentage point toward the end of the third quarter.<sup>7</sup>

Thirdly, there is reason to believe that these interest rate hikes did not fully reflect the intensity of the demand for nondirected credit during the first three quarters of 1973, for in revising interest rates the banks were forced by public pressure to exercise moderation.

Ex post facto it turned out that, despite the signs of a growing tightness in the money market in 1973 after the previous year's relative abundance of liquidity, the heavy demand pressures in the economy were not effectively curbed and in fact they grew sharper during the first nine months of 1973. There were two reasons for this: first, the buildup of excess liquidity in previous years, the diminished demand for money, and the growth of the money supply in 1973 permitted a further notable expansion of economic activity; and second, the actual amount of liquidity in the economy in 1973 was probably greater than shown by the conventional indicators.

In order to quantify the effect of the various explanatory factors, we ran a regression equation of the demand for money (defined both narrowly and broadly) as a function of prices, short-term interest rates, and the level of economic activity. Although the investigation has not yet been completed, a number of preliminary findings for the first nine months may be noted.

As regards the quantity of money narrowly defined ( $M_1$ ), in 1972 there was an excess supply which amounted to between 1 and 4 percent of its average monthly balance that year. In the first nine months of 1973 the aggravation of inflation dampened the demand for money at a rate ranging between 3 and 6 percent of the average monthly balance of the money supply during this period. Because of these two factors even the relatively sluggish monetary expansion during these months resulted in an equilibrium between the demand and supply of money.

The picture is a little different for the money supply broadly defined ( $M_2$ ). It is doubtful whether in 1972 there was an excess supply of  $M_2$ , but the accelerated rise of prices had a stronger impact on it than on  $M_1$ . On balance, the various demand equations for  $M_2$  show that during the first nine months

<sup>6</sup> This calculation applies to the entire banking system and is based on the unrealistic assumption that the liquidity position was identical in all the banks.

<sup>7</sup> The rate was set at 17.5 percent (of which one point is defined as a commitment fee). This does not reflect all the cost components of bank borrowing, and hence it should be regarded as merely an indicator of changes in the interest rate level.

of 1973 there was an excess demand amounting to 3–9 percent of its annual average level.

These calculations indicate that, while in 1973 there was no shortage of money as narrowly defined, there was an overdemand for interest-bearing liquid assets. That this did not lead to an even greater tightness in the financial market during the first three quarters of 1973 can apparently be ascribed to the institutional constraints on the banks' interest rate policy during this period, as a result of which the financial market situation was not fully reflected by the prevailing interest rates or liquidity deficiencies. Another reason was the availability of interest-bearing liquid assets in the form of linked bonds. In 1973 part of the public evidently changed its attitude toward linked bonds, which began to become more a near substitute for demand and time deposits and the Short-Term Loan instead of being only a medium-term savings instrument, as before. Until September the bonds served as a substitute mainly for time deposits and the Short-Term Loan, but in December they apparently began to substitute for demand deposits as well.

This change in the function which linked bonds are filling in the public's assets portfolio is connected, as already mentioned, with the sharpening of inflation, which began to assume serious dimensions in the last quarter of 1972,<sup>8</sup> and has become even more rampant since the final quarter of 1973.

The heightening of inflation enhances the advantages of holding linked bonds, as it drives up their nominal yields without increasing the risk element. The faster the rise of prices in the economy, the greater the increase in nominal yields and the diminution of risk, so that linked bonds progressively become a good substitute for conventional liquid assets for a holding period of several months or even weeks.

To appreciate how the risk element has diminished in a linked bond investment, it should be noted that during the 12 months preceding the October war inflation added an average of 2 percentage points a month to the value of the bonds. What is more, although a rise in the real rate of interest in the bond market may depress the price of such paper, the expected magnitude of the change is small owing to the stable rates of return fixed by the Government on new issues, and also because of the large weight of institutional investors, who are a stabilizing factor in the secondary bond market.<sup>9</sup> Furthermore, in Israel most of the bonds traded in the secondary market have a

<sup>8</sup> Whereas between January and September 1972 prices rose 6.4 percent, in the final quarter of the year they went up by 5.6 percent and in the first nine months of 1973 by 15.8 percent (seasonally unadjusted data).

<sup>9</sup> The fact that debitory interest rates in the first nine months of 1973 were much lower than bond yields, together with the tax concessions granted on such yields, contributed to their stability. In other words, for a nonbank investor it paid to borrow at the going bank rate to finance bond purchases, while from the banks' standpoint bond holdings were just as profitable as the granting of nondirected credit.

relatively short life, so that changes in their real yields do not cause their prices to oscillate sharply.

Because of these changes in the properties of value-linked bonds, it may be assumed that at least part of the stock at the end of 1972 and the additional bonds purchased during the first nine months of 1973 were held for liquidity purposes; hence the relatively laggard growth of the money supply broadly defined.

The stock of linked bonds (option-type loans, the Absorption Loans, and the 6.5 percent issues held by the public<sup>10</sup>) neared the IL 3,000 million mark at the end of 1972; during the first nine months of 1973 it expanded by an additional IL 1,100 million as a result of new issues, the appreciation of the existing stock, and the continued distribution of Absorption Loan certificates.

The sheer magnitude of these figures suggests that even if only part of the stock of linked bonds was being held for liquidity purposes, this would significantly alter the monetary picture. In this case the calculated increase in the money base, money supply, and unlinked assets in 1973 understates the actual amount of liquidity held by the public. This means that, contrary to what the conventional measures show, the public's liquidity did not decelerate rapidly enough and the monetary developments failed to effectively curb the demand pressures which existed during the first nine months of 1973. This applies in particular to the period since the end of 1973, but it is very likely that the shift in the role played by bonds began in the early part of the year, although it was less prominent then.

It must be stressed that the foregoing is based on circumstantial evidence only (described below), for the assumed change in the function of value-linked bonds cannot be proved from past experience. In the early 1950s, when prices mounted almost as fast as in 1973, no value-linked bonds existed. These began to be issued only in 1961, but from then until the end of 1970 the general price level moved up by an average of only 6 percent a year, with the steepest advance being 10.2 percent (1962).

Support for the above hypothesis may be found in the following developments:

(a) Purchases of linked bonds took on hectic proportions between November 1973 and January 1974, and during this period the money supply decreased by 4 percent in nominal terms and demand deposits and the Short-Term Loan plummeted 13 percent. If we add to this the 11 percent depreciation in the real value of these assets because of the rampant inflation and the anticipated stronger demand for money because of the military situation, an acute monetary squeeze might have been expected.<sup>11</sup> This did not occur

<sup>10</sup> Excluding bonds purchased by banks for their approved saving schemes and those bought by social insurance funds.

<sup>11</sup> The influence of the national emergency on the demand for liquidity is not very clear, since it was accompanied by a marked slackening of economic activity. However, the political and economic uncertainties might have been expected to lead to the deferment of business transactions and to an increased holding of liquidity until clarification of the picture.

because the swelling volume of linked bond purchases—which in these months came to almost IL 1,200 million net—represented not so much an accretion to the public's savings as a reshuffling of its liquid assets portfolio.

To be sure, the expectation of a further rise in prices during this period, and in the latter part also of a worsening of the terms of new linked bond issues, was much stronger than in the first nine months of 1973, although it was undoubtedly present then, albeit in a weaker form.

(b) The rise in the proportion of currency in circulation in 1973 and the decline in that of time deposits and the Short-Term Loan, which began in 1972 and grew sharper in 1973, also suggest that part of the requisite liquidity was supplied from unconventional sources. Initially there was apparently some substitution of linked bonds for unlinked interest-bearing assets, and subsequently also for demand deposits.

(c) These developments help to explain the failure of real bond yield rates to rise, as well as the enormous expansion of the public's linked bond portfolio in the first nine months of 1973, despite the decline in the rate of household saving, for the first time in years. It may reasonably be assumed that the heavy purchase of consumer durables during this part of 1973 was accompanied by the sale of bonds, or a halt in purchases of new issues, by households which had held them as a savings medium, and that they were picked up by other sectors which regarded them as a substitute for liquid assets.

(d) In 1972 and 1973 there was an enormous surge in linked bond turnover in the secondary market. The underlying factors and reservations as to the reliability of the data are discussed in Chapter XV "The Securities Market". Here we shall only reiterate that the huge dimensions of this trade probably reflected the growing use of value-linked bonds as a substitute for liquid asset holdings and not merely as a savings instrument.

(e) Additional support for our hypothesis may be found in the fact that, as already mentioned, the conventional measures of the public's liquidity indicate an overdemand for money as broadly defined, which should have resulted in some tightness in the financial markets. If our assumption about the changed role played by linked bonds is valid, the relatively mild rise in interest rates and the creation of liquidity deficiencies in the first nine months of 1973 should not be ascribed solely to institutional factors, but must also be ascribed to the growing use of linked bonds as an instrument for holding liquidity for short periods.

#### (b) *Postwar developments*

Since October there has been a sizable liquidity infusion, and the conventional indicators also point to a substantial buildup of liquidity by the end of the year. At the same time expectations of a further sharpening of inflation and a devaluation of the IL have mounted noticeably since December, accom-

panied by an even bigger flurry of linked bond and foreign currency purchases. Any discussion of the economy's liquidity during this period must take into account, even more so than in the preceding period, the swelling linked bond portfolios, since the substitution of this paper for money increased initially with the growing inflationary expectations and subsequently also with the expectation of a worsening of the terms of new bond issues.

Section 3 below gives a detailed description of the policy tools employed for injecting additional liquidity into the economy since October. Suffice it here to reiterate that upon the outbreak of war the Treasury and the Bank of Israel introduced a policy of liquidity infusion in order to prevent the interruption of economic activity because of a scarcity of liquidity. The large-scale mobilization of manpower and civilian equipment greatly reduced the economy's productive capacity, and this, along with the prevailing economic and political uncertainties, was liable to lead to some idleness of the available factors of production.

Various signs point to the absence of a liquidity squeeze in the postwar period or to a shortage of credit in most economic sectors, although it is possible that a few enterprises encountered difficulties.

The 14 percent expansion of the money base in October and November and the 10.4 percent rise in the money supply (both figures seasonally adjusted) reflect a heavy liquidity infusion. The prolongation of the extensive mobilization until the middle of the first quarter of 1974, the slackening of consumer buying, and the uncertainty as to when the reservists would be demobilized and what direction economic development would take precluded any modification of policy until the end of the first quarter of 1974, since the overriding aim was to avert as far as possible any upsetting of economic activity.

However, it seems that since December (and particularly in January 1974) monetary developments have taken an undesirable turn because of speculative factors. The money base tapered off in December and in January it dropped by seasonally adjusted 12 percent. The money supply edged up only 1.6 percent in December, and fell 5.5 percent in January (seasonally adjusted data). But the decline in liquidity indicated by these conventional measures is misleading, since the Treasury and the Bank of Israel pumped considerable liquidity into the economy during these months.

The contraction of the money base and the money supply was caused by the purchase of foreign currency and linked bonds on an unprecedented scale in anticipation of a devaluation of the IL, as well as by the acceleration of inflation due to the raising of petroleum prices, the paring of subsidies, and the expectation of other price increases.

Most of the additional bond purchases were probably made by the household sector, which financed them by drawing down its holdings of Short-Term Loan certificates and time and demand deposits, while the bulk of the foreign currency purchases—which were necessitated by the advancing of payments

to the rest-of-the-world sector and the deferment of receipts from the latter—were made by private business, which financed them largely by borrowing from banks.<sup>12</sup>

A factor stimulating these speculative purchases—which, as just noted, were financed at least partly by bank credit—was the cutting after the outbreak of war of the penalty rates for liquidity deficiencies to half or even a third of their pre-October level.

In the postwar months the monetary authorities refrained from diminishing the liquidity infusion or switching to an absorption of funds despite the signs of an abundance of liquidity, for fear that the speculative demand for bonds and foreign currency would create liquidity problems with a consequent slump in economic activity.

The volume of linked bond and foreign currency purchases is a suitable indicator of the liquidity of the economy since the war. In December 1973 and January 1974 we find that purchases of Government loans by the public grossed IL 1,350 million (including the investment of saving scheme funds), compared with IL 575 million in December 1972 and January 1973.<sup>13</sup> Net purchases of foreign currency by the private sector from the Bank of Israel in December 1973 and January 1974 amounted to approximately \$ 250 million, compared with \$ 65 million in net sales in the corresponding months of the previous year. Part of the increase in the private sector's foreign currency dealings can obviously be attributed to the widening of the deficit in the country's goods and services account in 1973, but there is no doubt that another major factor was the expectation of a devaluation of the IL. (The data for February and March 1974 reveal a continuation, albeit less pronounced, of this trend.)

The growing shift to linked bonds and foreign currency assets, together with the decreased conversion of Pazak and Tamam funds, was accompanied by a much heavier borrowing from banks and the consequent incurring of sizable liquidity deficiencies in mid-December, which continued to grow in January and February 1974. In March 1974 the banks upped the debitory interest rate by one point to 18.5 percent.

<sup>12</sup> This is not to imply that businesses did not buy bonds or that all those bought by households were financed from own means and not—at least partly—by the receipt of credit. Presumably these developments occurred mainly in January, when expectations arose of a steep rise in the consumer price index and a deterioration in the terms of new linked bond issues.

<sup>13</sup> Redemptions in December 1973 and January 1974 are estimated at IL 100 million and purchases for approved saving schemes at IL 150 million; thus the general public directly and indirectly increased its bond holdings by approximately IL 1,100 million during these two months.

### 3. MONETARY POLICY AND THE LIQUIDITY OF BANKING INSTITUTIONS

#### (a) *The first nine months of 1973*

The growth of the money base and the public's deposits during the first nine months of 1973 slowed noticeably compared with the corresponding period the year before, and there were significant changes in the composition of the monetary expansion. First of all, the external liquidity infusions diminished during these months, mainly because of balance of payments developments, which were only partly offset by the increased Government infusion (see Tables XIII-3 and XIII-4). The deceleration of monetary expansion was connected with the decreased contribution of the private sector's foreign currency transactions, which outweighed the effect of the larger public sector infusion. After mopping up liquidity in 1972, the public sector did not take any further absorptive action in the year reviewed. In other words, the slackening of monetary expansion cannot be credited to a more vigorous absorption effort by the Treasury and the Bank of Israel, but resulted from a deterioration in the balance of payments position because of the acceleration of inflation in 1972 and 1973. Moreover, in view of what was said in section 2 above about the factors that prevented monetary policy from braking the

Table XIII-3

#### I. EXTERNAL INFUSIONS, BY COMPONENT, 1971-73

(IL million)

End of period	Net foreign currency assets at the Bank of Israel	Bank of Israel credit			Total external infusions
		To the Govt.	To the Jewish Agency	To the public	
1971	2,299	5,113	125	880	8,417
1972	4,689	4,565	415	859	10,527
1973	7,398	3,825	354	1,383	12,960
January	4,798	4,362	411	882	10,454
February	5,355	4,225	410	832	10,822
March	5,699	3,866	409	822	10,796
April	5,714	4,224	405	892	11,235
May	5,792	4,347	399	920	11,457
June	6,049	4,636	398	1,070	12,154
July	6,626	4,587	391	1,191	12,796
August	6,319	4,653	379	1,315	12,667
September	6,542	4,699	365	1,312	12,919
December	7,398	3,825	354	1,383	12,960

NOTE: Publication of the figures for October and November was forbidden because of the national emergency.

<sup>a</sup> Excluding capital and sundry accounts and nonliquid bank deposits with the Bank of Israel.

Table XIII-3 (contd.)

## II. ASSETS CREATED BY EXTERNAL INFUSIONS, 1971-73

(IL million)

End of period	Short-Term Loan outstanding <sup>b</sup>	Currency in circulation	Net foreign currency balances of banking institutions with Bank of Israel	Balances in transit and other accounts	Liquid assets <sup>c</sup> of banking institutions	Total assets created by external infusions
1971	714	1,584	4,169	-7	1,955	8,417
1972	745	1,974	4,755	23	3,030	10,527
1973	433	2,715	6,092	132	3,588	12,960
January	705	1,966	4,784	36	2,963	10,454
February	718	2,021	5,258	-8	2,833	10,822
March	715	2,087	5,403	-16	2,607	10,796
April	743	2,158	5,406	-27	2,954	11,234
May	759	2,183	5,519	3	2,993	11,457
June	776	2,289	5,998	33	3,058	12,154
July	797	2,313	6,542	20	3,125	12,797
August	811	2,370	6,184	20	3,282	12,667
September	823	2,424	6,355	23	3,294	12,919
December	433	2,715	6,092	132	3,588	12,960

<sup>b</sup> Includes certificates held by the banks.<sup>c</sup> Excludes nonliquid bank deposits and exemptions from the liquidity requirements.

growth of demand during the period reviewed, what was called for was a more resolute effort to check the expansion of the money base and money supply through a coordinated fiscal-monetary policy.

Secondly, there was a drastic shift in the public's demand for financial assets, which precluded the expansion of credit by much more than can be attributed to the decelerated growth of the money base. Currency accounted for 51 percent of the increase in the money base during the first nine months of 1973, compared with only 31 percent in the corresponding period the year before, while the weight of time deposits in the public's unlinked bank deposits declined sharply following a zero growth during the period reviewed. The components showing a rapid upswing in 1973 were currency in circulation and demand deposits—assets which hardly affect the banks' capacity to step up credit to the public—while time deposits, which are subject to a low liquidity ratio, did not grow at all. This period saw the bulging of approved saving scheme deposits, but this too did not constitute a source of credit expansion, since the deposits require almost 75 percent liquid cover, and in investing such funds

allowance must be made for the fact that the liabilities to depositors are value-linked.

Thirdly, because of the burgeoning demand for credit and the sluggish rise in the banks' loanable funds, the banking institutions were in a deficit liquidity position throughout this period. The daily average of their overall deficiency began to move up in January, reached a seasonal peak in April, and declined sharply in May and June (see Table XIII-6). It is important to note in this connection that the raising of IL 350 million of equity capital through share and capital note issues enabled the banks to step up their lending operations without incurring even greater deficiencies.

Fourthly, the inflation heightened the demand for bank credit, especially in the first quarter of the year. The debitory interest rate was upped by one percentage point toward the end of the third quarter, but the banks were unable to fully meet the demand during the entire period.

In the first quarter of 1973 the money supply more or less held steady, the money base contracted sharply, and ordinary bank credit and liquidity deficiencies rose precipitately. The reduction of the money base continued the trend begun in the second half of 1972, while in the first quarter of 1973 it was mainly the deferment of disbursements by the Government that arrested the monetary expansion. The Government invariably siphons off liquidity in the first quarter of the year, but in 1973 it endeavored to put off disbursements until the new fiscal year, particularly those that were not budgeted from the start. At the same time, the slackening of foreign currency conversions by the private sector, evident from the middle of 1972, grew more pronounced, so that this expansionary factor did not offset the Government's absorptive operations.

In the first quarter of 1973 the money base broadly defined declined by IL 290 million, or 5.3 percent, compared with an increase of 6.5 percent in the corresponding period of 1972 (see Table XIII-5).<sup>14</sup>

The seasonal contraction of the money base and the sustained high level of economic activity fueled the demand for bank credit: nondirected credit expanded by 14.5 percent from the end of December 1973 to the end of March 1974, and total bank credit to the public by 9.8 percent. This explains why the massive absorption by the Government notwithstanding, the quantity of money did not decrease during this period. The swelling volume of nondirected credit, which rapidly depleted the banks' free reserves, caused their liquidity deficiencies to soar from approximately IL 50 million at the end of December 1972 to nearly IL 500 million at the beginning of April 1973.

<sup>14</sup> The shrinkage of the money base in the first quarter of 1973 stands out even more when compared with the corresponding period of 1972, since part of the absorption in March 1972 (which amounted to IL 150 million) was effected on the last day of the fiscal year and was pumped back into the economy a few days later.

The monetary situation underwent a dramatic change in April, and between then and the end of September the money supply rose by an average of 3 percent a month.

The turnabout in liquidity supply in the second and third quarters of 1973 stemmed from the large-scale infusion engendered by the Government's budgetary operations; in the second quarter approximately IL 400 million was injected into the economy and in the third quarter another IL 200 million. Added to this were the sums arising from the private sector's foreign currency dealings, which reached a seasonal peak in April-May.

It was these infusions that permitted the rapid expansion of the money supply and the money base (the latter by 23.3 percent) between April and September, even though nondirected credit was not stepped up and the banks' liquidity deficiencies were cut drastically.<sup>15</sup> The growth of the money base did not proceed at an even pace during these six months: in April, June, and August it shot up sharply, while in May, July, and September the increase was relatively mild. In the latter months nondirected credit rose steeply, but declined (or increased more slowly) in those months which witnessed substantial external infusions.

Until the outbreak of war the Bank of Israel's monetary policy was aimed at curbing the strong demand pressures prevailing in the economy and retarding the rate of monetary expansion. The principal measures adopted were as follows:

(a) Between January 11 and February 8 the central bank scaled up the liquidity ratios on time deposits by 2 percentage points, bringing them up to 25 percent for deposits for six months and longer and to 30 percent for those made for four to six months. This added IL 78 million to the banks' required liquid asset cover.

(b) The banks were required to participate in the Imports-for-Exports Fund, a step that absorbed IL 50 million. While the credits given by this fund are in foreign currency, the banks were obligated to deposit with the Bank of Israel a sum equal to 65 percent of the funds' total lending. Half of this amount had to be deposited on February 22 and the other half on March 14.

(c) Together with these absorptive measures, the Bank of Israel infused IL 25 million during the first quarter through its open-market operations. The contraction of Short-Term Loan holdings from November 1972 until the early part of January 1973 prompted the Bank of Israel to conclude an underwriting agreement with the commercial banks with a view to preventing the further injection of liquidity into the economy from this source. Under this

<sup>15</sup> While total bank credit to the public expanded during this period, most of the increment consisted of foreign currency credit to the diamond industry and that authorized by the Treasury's Foreign Exchange Department.

Table XIII-4

## INFLUENCE OF THE PUBLIC AND PRIVATE SECTOR ON THE MONEY BASE (NARROWLY DEFINED), 1972-73

(IL million; [+] denotes an increase and [-] a decrease)

	Jan.-Sept.		Oct.-Dec.		Entire year	
	1972	1973	1972	1973	1972	1973
Government and National Institution operations <sup>a</sup>	-325	6	-280	731	-605	737
Private sector foreign currency transactions	2,054	1,212	490	-499	2,544	713
Net foreign currency transactions <sup>b</sup>	2,090	585	460	-358	2,550	227
Foreign currency credit from the Bank of Israel	-36	627	30	-141	-6	486
Change in foreign currency deposits of the public (mainly Pazak and Tamam) <sup>c</sup>	-411	-340	-90	-250	-501	-590
Bank of Israel credit to the public in IL	14	-153	-71	211	-57	58
Open-market operations	-87	-82	52	390	-35	308
Other factors <sup>d</sup>	61	115	48	110	109	225
Total increase in money base <sup>e</sup>	1,306	758	149	693	1,455	1,451

<sup>a</sup> Net withdrawals from the Bank of Israel by the Government, plus net sales of foreign currency to (or minus net purchases of foreign currency from) the Bank of Israel by the Government.

<sup>b</sup> The increase (or decrease) in net foreign currency assets at the Bank of Israel, less (plus) exchange rate differentials, less (plus) net sales of foreign currency by the Government and less Bank of Israel foreign currency income.

<sup>c</sup> The change in these balances, less (plus) exchange rate differentials.

<sup>d</sup> Net income of the Bank of Israel, plus net exchange rate differentials.

<sup>e</sup> These figures differ slightly from those in Table XIII-3 because they were taken directly from the Bank of Israel's balance sheet, while the latter are from the balance sheets of the commercial banks.

agreement the banks undertook to increase the balance of the Short-Term Loan in circulation by approximately IL 4 million a week until by the end of November it stood IL 140 million above its mid-January level. The agreement did not call for any increase in March, since no liquidity surplus was expected that month.

(d) After the huge infusion in April and the whittling down of the banks' liquidity deficiencies, the Bank of Israel renewed its absorptive operations on May 17, raising the banks' participation in the Export Production Fund by 20 percentage points to 65 percent. As a result, the banks had to increase their deposits with the Bank of Israel by a total of IL 118 million. The timing of the absorption was determined mainly in relation to the growth of time deposits, and since these have not risen at all since May, the absorption of funds through this measure has been fairly sluggish. But it is important to note that the method of calculating the banks' obligatory deposits is designed, first and foremost, to avert the expansion of nondirected credit to the public. The balance of such credit at the end of August was in fact reduced to its mid-May level.

(e) In July the Bank of Israel clamped a 100 percent liquidity ratio on nondirected bank credit in excess of its balance on the 18th of that month. This step was accompanied by the imposition of fines for deficiencies in liquid asset cover against credits. This measure, which was to be in force for a limited period of four months, was intended to spur the banks to reduce the large deficiencies incurred in July. This was the first time that the Bank of Israel exercised its authority and obligated the banks to maintain liquidity against credit. In the past it had contented itself with fixing credit ceilings. This step did not directly siphon off any liquidity, since by the time it was lifted in October the balance of nondirected credit had failed to regain its high level on the determining date. Nevertheless, the volume of such credit began to decline in the second half of July—partly because of the large liquidity infusion in August, but to some extent also because of this measure.

To sum up, during the first nine months of 1973 the Bank of Israel took action to absorb liquidity, in continuation of its policy of the past few years. But the amount mopped up was smaller than in 1972: whereas in the first nine months of that year the Bank succeeded in siphoning off IL 470 million by scaling up liquidity ratios and revamping the structure of the directed credit funds, in 1973 the figure came to only IL 190 million. There were two reasons for the smaller absorption in the year reviewed.

First, the infusion engendered by the Government's operations and balance of payments developments was considerably smaller in January-September 1973 than in the corresponding period of 1972. As a result the money base, money supply, and time deposits increased more sluggishly in the year reviewed.

Secondly, the uneven path traced by the monetary aggregates during the period discussed hampered the Bank's conduct of an absorption policy. The

**Table XIII-5**  
**THE MONEY BASE, BY COMPONENT, 1971-73**  
(IL million)

End of period	Currency in circulation	Liquid assets of banking institutions	Money base, narrowly defined (1+2)	Liquidity exemptions	Authorized liquidity deficit	Money base, broadly defined		
						Original data (3+4+5)	Percent increase	
							Original data	Seasonally adjusted
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1971	1,584	1,955	3,540	635	—	4,175	43.2	
1972	1,974	3,030	5,004	474	4	5,482	31.3	
1973	2,715	3,588	6,303	608	25	6,936	26.5	
January	1,966	2,963	4,929	477	—	5,406	-1.4	0.0
February	2,021	2,833	4,854	487	25	5,366	-0.7	-1.5
March	2,087	2,607	4,694	492	—	5,186	-3.4	-1.4
April	2,158	2,954	5,112	470	—	5,582	7.6	4.8
May	2,183	2,993	5,176	443	112	4,731	2.7	1.0
June	2,289	3,058	5,347	464	106	5,917	3.2	2.2
July	2,313	3,125	5,438	515	105	6,058	2.4	1.4
August	2,370	3,282	5,652	547	119	6,318	4.3	5.2
September	2,424	3,293	5,717	551	95	6,363	0.7	0.7
October	2,678	3,614 <sup>a</sup>	6,292	547	79	6,918 <sup>a</sup>	8.7	11.3
November	2,671	3,796 <sup>a</sup>	6,467	539	66	7,072	2.2	2.4
December	2,715	3,588	6,303	608	25	6,936	-2.0	-1.8

<sup>a</sup> Provisional data.

sharp veering from a 3 percent average monthly growth of the money base broadly defined in the last quarter of 1972 to a precipitate decline in the first quarter of 1973 led to the creation of liquidity deficiencies of unparalleled dimensions and aroused resistance to the pursuance of an absorption policy at the beginning of the second quarter. An additional factor was the changed composition of the monetary expansion—the halting of the uptrend in time deposits, and hence also in the banks' loanable funds.

(b) *The postwar period*

Since the war the monetary authorities have carried out an expansionary policy, at first out of a desire to meet the special liquidity needs arising during the period of fighting, and subsequently in order to avoid the disruption of economic activity because of the mobilization of manpower and equipment and the uncertain business outlook. Even between the time when the disengagement agreements went into force and the end of the 1973/74 fiscal year monetary policy was not modified, for the existing mood of uncertainty aroused fears of a slump in economic activity. Together with the desire of the monetary authorities to supply the additional liquidity required to tide the economy over during the emergency, since December there has been a strong demand for credit, which is connected not so much with the emergency situation as with the financing of bond and foreign currency transactions. Apprehensive lest any action against such dealings should affect the legitimate credit needs, the authorities persisted in the infusion policy in the first quarter of 1974 as well. But in March it was decided to restore the penalties for liquidity deficiencies to their pre-October level, with effect from the beginning of May. Furthermore, in March the bank rates were upped in order to bring them more in line with the accelerated rise in prices.

October saw a huge withdrawal of deposits, which began immediately upon the outbreak of fighting. But since this had happened in previous war periods, it did not come as a surprise. During the month currency in circulation with the public soared IL 254 million; this severely depleted the banks' liquidity reserves, which had already been badly strained in the previous month, when their combined deficiency jumped to IL 350 million (on October 3). The swelling of the deficiency in September was due to the buoyant seasonal demand, which resulted in a much larger volume of credit being granted to the public, even though the banks' liquid assets did not grow that month.

The new monetary policy measures, introduced in the first week of fighting, were designed to enable the banks to meet the heavy demand for cash, prevent the contraction of credit to the banks' clients, and avert the interruption of production and marketing because of a credit shortage.

The first step was to release the banks from their obligation under the Short-Term Loan underwriting agreement; this resulted in the injection of

**Table XIII-6**  
**INDICATORS OF THE LIQUIDITY POSITION OF BANKING**  
**INSTITUTIONS, 1971-73**

(percentages)

End of period	Actual liquidity ratio on ordinary deposits	Liquidity exemptions <sup>a</sup>	Formal liquidity ratio on ordinary deposits (1+2)	Required liquidity ratio on ordinary deposits	Free reserves (IL million; surplus +, deficit -)		Free reserves as a percent of liquid assets held (daily average)
					End of month <sup>b</sup>	Daily average during month	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1971	48.2	22.7	70.9	67.5	106	131	7.0
1972	57.5	13.2	70.7	72.0	-47	-33	-0.9
1973	52.5	13.6	66.1	72.0	-280	-66	-1.5
January	56.6	13.3	69.9	72.0	-76	-103	-2.8
February	50.8	14.4	65.2	72.0	-245	-224	-6.2
March	46.2	13.7	59.9	72.0	-441	-267	-7.5
April	51.1	12.6	63.7	72.0	-310	-416	-11.4
May	53.9	14.8	68.7	72.0	-125	-276	-7.5
June	53.2	14.3	67.5	72.0	-181	-156	-4.1
July	50.9	15.5	66.4	72.0	-231	-249	-6.5
August	53.9	16.0	69.9	72.0	-86	-113	-2.9
September	52.1	14.8	66.9	72.0	-223	-165	-4.1
October <sup>b</sup>				72.0	-52	-244	-5.8
November <sup>b</sup>				72.0	21	105	2.4
December	52.5	13.6	66.1	72.0	-280	-66	-1.5

<sup>a</sup> Including authorized liquidity deficits.

<sup>b</sup> Provisional data.

some IL 30 million a week beginning October 10. Subsequently a IL 100 million stopgap rediscount facility was made available to the banks, and in November it was decided to slash the penalties for liquidity deficiencies from the 10-17 percent rate previously in force to a mere 5 percent; this too was meant as a temporary emergency measure.

Along with the measures to bolster the banks' liquidity position, action was taken to solve the financing problems of specific branches and sectors; these steps, which were due to be in force for a limited time, further augmented the banks' liquidity. Immediately after the outbreak of fighting, arrangements were made for financing export shipments which had been held up because of the war—at first by credits from the Fund for Financing Export Shipments and subsequently by rediscounting exporters' bills.

Later on rediscount facilities and credits within the framework of liquidity exemptions were provided to industry, crafts, agriculture, and transportation.

Only exporters and agriculture received this assistance in the form of directed credit; all other recipients were charged interest only slightly below the going market rates.

The various steps taken in October by the Bank of Israel resulted in a IL 283 million liquidity infusion, which slightly exceeded deposit withdrawals that month.

The Treasury also injected considerable liquidity in October, by speeding up disbursements to Government suppliers and effecting payments in cash wherever possible. As a result of these measures and of some lag in indirect tax collections, the Government infused a total of IL 330 million that month, which was much greater than in previous months.

In contrast to these expansionary factors, the foreign currency transactions of the private sector had an absorptive effect, as instead of a net sale of foreign currency to the Bank of Israel it ended up with a small net purchase.

Because of wartime conditions and the massive infusion by the Treasury and the Bank of Israel, the balance of nondirected credit plunged IL 180 million between October 3 and October 31. Along with some increase in the public's demand deposits and the swelling of the banks' liquid assets, this reduced the liquidity deficiencies of the latter by IL 300 million by the end of the month despite the low penalty rates in force.

In November and December it became increasingly clear that the main obstacles to the restoration of normal economic activity were the shortage of manpower and transport and in several branches a weakening of demand. The continued downward drift in nondirected credit in November, the unprecedented demand for linked bonds in November and December, and various other indicators showed that the economy was not suffering from a scarcity of liquidity. The Bank of Israel therefore virtually halted the injection of liquidity through the provision of credits in November and December. To be sure, its operations in the open market (the reduction of Short-Term Loan holdings) pumped in some IL 140 million a month, but it may be reasonably assumed that the final outcome was an insignificant injection, since the sums obtained from the redemption of Short-Term Loan certificates were reinvested in linked assets—bonds and approved saving schemes—so that they wound up in the Treasury's coffers.

The Treasury continued to speed up disbursements in November, those to domestic suppliers far exceeding the prewar level. Nevertheless, the amount of money infused into the economy dropped to IL 284 million in November and IL 103 million in December, since proceeds from the sale of linked Government and financial institution bond issues to the public reached record heights.

The fall in private sector sales of foreign currency operated, as already mentioned, in the opposite direction. The shift from a net sale to a net purchase began in October and gained impetus in December and the first quarter of

1974. This was probably connected with the expectation of a devaluation of the IL after the elections, as suggested by the price rise of assets linked to the foreign exchange rate. (In many ways this recalled the situation in the period preceding the elections of November 1969.) Even though the net amount of foreign currency purchased by the private sector was not large in comparison with exports, imports, and foreign transfer and credit receipts, it had an important bearing on the direction of monetary development.

The net result of the external infusions was a IL 186 million surge in the banks' liquid assets in November and a IL 73 million drop in December. The uptrend in currency in circulation with the public ceased in November, but in December the level edged up a notch.

Despite the more sluggish liquidity infusion, nondirected credit continued to tumble in November; on the 28th of the month the banks had an aggregate liquidity surplus of IL 94 million, even though two days earlier the Bank of Israel had called in its IL 100 million emergency rediscount facility.

The uptrend in nondirected credit reasserted itself in December, accompanied by the reappearance of liquidity deficiencies in the second half. In the same month the impact began to be felt of the reduced penalty rates, which serve as a sort of "safety valve" for regulating the economy's liquidity at a time of an unexpected large-scale absorption due to balance of payments developments or the Government's operations. Under such circumstances sharp fluctuations in the liquidity situation are liable to cause undesirable shifts in the supply of bank credit to the public, undeservedly harming certain branches and units in the economy. The Bank of Israel therefore decided to extend the reduced penalties to the beginning of May 1974.<sup>16</sup>

In December the authorities were still unable to foresee the dimensions which purchases of bonds and foreign currency assets were likely to reach in the near future. Even though nondirected credit soared by nearly IL 400 million in December and the banks' reserves sank by approximately IL 300 million, the balance of nondirected credit at the end of the month was only slightly higher than at the end of September.

In January 1974 the speculative transactions reached their peak; the surging sales of bonds and foreign currency assets were accompanied by the swelling of nondirected credit and the slashing of nearly IL 900 million from the banks' liquid asset cover. This trend carried over through February, when their liquid assets shrank by a further IL 200 million. The smaller drop that month was due to the discontinuation in the first week of the issue of option-type and 6.5 percent linked bonds; with the renewal of issues toward the end of the month the terms offered the public were much less favorable than before. In addition, February usually witnesses a seasonal increase in foreign

<sup>16</sup> Originally scheduled to be in force until November 28, they were extended three times—initially until January 2, then until April 3, and finally to the beginning of May, when they were to revert to their prewar level.

currency receipts, and this blunted the absorptive effect of the net purchase of foreign currency. It may also be reasonably assumed that even were it not for these two factors the volume of speculative transactions could not have been sustained on the same scale as in January. The impact of these developments on economic activity was discussed in section 2 above. Here it should be noted that on February 13 the banks' liquidity deficiencies reached an unparalleled IL 828 million (23 percent of their total liquid assets on that day).

The low penalty rates in force until May 1974 undoubtedly facilitated the purchase of foreign currency and bonds. However, the Bank of Israel refrained from upping them or adopting other measures to reduce the deficiencies for fear that this would affect precisely those establishments and branches that needed credit because of the emergency situation. What is more, most of the speculative activity occurred before the disengagement of forces, at a time when a large percentage of the manpower was still mobilized and it was doubtful whether demand pressures would exist in 1974 too.

Since the fines were not hiked and no action was taken by the banks to lower the deficiencies by curbing the volume of bank credit, the size of the deficiencies could not be regarded as indicative of the degree of tightness in the money market. In mid-January the Bank of Israel resumed the infusion of liquidity into the economy in an attempt to reduce the deficiencies. Intended to be only a temporary expedient, the infusion was to be immediately halted if at the beginning of 1974/75 the need for absorptive action seemed necessary. The Treasury, on its part, also took action to inject liquidity, both by altering the terms of new bond issues in February and by shelving some of the seasonal absorptive measures usually taken at the end of the fiscal year.

One of the steps adopted to reduce the banks' liquidity deficiencies was to cut their participation in the export funds by 15 percentage points on January 25 (this resulted in the injection of IL 187 million) and by another 10 points on February 28 (IL 131 million). In addition, on March 7 the liquidity ratios on time deposits were lowered by five points (from 25 to 20 percent) on six-month deposits and by four points (from 30 to 26 percent) on four-month deposits. This reduced the banks' required liquid asset cover by IL 180 million.

Along with these measures, the Bank of Israel decided to restore the penalty rates to their former level, and announced its intention of lifting the cuts in the banks' participation in the export funds should there be an exaggerated monetary expansion at the beginning of the 1974/75 fiscal year. In addition, in trimming the liquidity ratios on time deposits in March 1974, it attempted to persuade the banks to adjust the structure of their interest rates to the accelerated rise of prices. The large banks raised the interest on six-month deposits from 13.5 to 14.5 percent and the debitory interest on demand deposits by one point to 18.5 percent.

#### 4. MONEY SUPPLY

In 1973 the money supply increased by IL 1,805 million, or 32.4 percent, surpassing the previous year's 28.7 percent.<sup>17</sup> The growth did not proceed at an even pace during the year, even after deseasonalizing the data. In the first quarter the level held steady, but in the second and third quarters it moved up at an average monthly rate of some 3 percent (see Table XIII-7).

October saw a buoyant demand for money balances, particularly cash but also demand deposits. There was a heavy withdrawal of cash by mobilized reservists and the home front, and demand deposits expanded by 6.5 percent (7.7 percent seasonally adjusted) because of the deferred execution of transactions.<sup>18</sup>

The money supply inched up 1 percent (2.5 percent seasonally adjusted) in November and 2.6 percent (1.6 percent seasonally adjusted) in December. In January it fell 7.2 percent (5.5 percent seasonally adjusted), but in February the uptrend reasserted itself—by a mild 1.3 percent (1.2 percent seasonally adjusted).

In section 2 the sluggish increase in the money supply in December and its steep decline in January were attributed to the changing pattern of demand for liquid assets—in the main a shift to linked bonds and foreign currency assets.

The change in the currency-demand deposits ratio in 1973 is worthy of note. Whereas the share of currency in the money supply had declined almost unbrokenly from the middle of 1970 to the end of 1972, in 1973 it turned upward, a trend that has grown more pronounced since the month of fighting. This can apparently be attributed to the heightening of inflationary expectations at the beginning of 1973 and their further sharpening in the postwar months. This trend may be seen in Table XIII-7, and it stands out even more if data for the first part of 1974 are added.

Between the end of September 1973 and the end of February 1974 currency in circulation with the public rose 12.2 percent, whereas demand deposits went up by only 4.3 percent (seasonally adjusted data). This brought up the share of currency in the money supply from 57 to 62 percent during this period. It may be assumed that by the end of February the public had readjusted its liquid asset holdings after the heavy cash withdrawals in October, so that the growth of currency can be ascribed predominantly to the inflationary nominal increase in the economy's transactions from the last quarter of

<sup>17</sup> The increase in the money supply during 1973 necessitated the submission of two reports, in accordance with section 35 of the Bank of Israel Law. The first, covering the period from the end of July 1972 to the end of June 1973, was submitted in the middle of July, and the second, which dealt with the period from the end of June to the end of October 1973, was submitted in the middle of February 1974.

<sup>18</sup> The reference is to households and various economic units whose receipts were not affected by the war but which nevertheless put off payments.

Table XIII-7  
**THE MONEY SUPPLY, MONTHLY, 1973**  
 (IL million)

End of period	Currency <sup>a</sup>				Demand deposits <sup>b</sup>		Money supply		Money supply, seasonally adjusted	
	Total	Percent monthly increase	Percent of money supply		Total	Percent monthly increase	Total	Percent monthly increase	Total	Percent monthly increase
			Original data	Seasonally adjusted						
1972 December	1,974	0.3	35.3	35.3	3,613	4.6	5,587	3.1	5,606	2.1
1973 January	1,966	-0.4	35.7	35.0	3,545	-1.9	5,511	-1.4	5,623	0.3
February	2,021	2.8	36.5	36.0	3,518	-0.8	5,539	0.5	5,642	0.3
March	2,087	3.3	37.1	36.8	3,542	0.7	5,629	1.6	5,664	0.4
April	2,158	3.4	36.9	37.4	3,698	4.4	5,856	4.0	5,769	1.8
May	2,183	1.2	37.0	37.1	3,721	0.6	5,904	0.8	5,882	2.0
June	2,289	4.9	36.9	37.4	3,907	5.0	6,196	4.9	6,108	3.9
July	2,313	1.0	36.9	37.1	3,962	1.4	6,275	1.3	6,228	2.0
August	2,370	2.5	36.8	36.7	4,070	2.7	6,440	2.6	6,434	3.3
September	2,424	2.3	36.2	36.5	4,271	4.9	6,695	4.0	6,604	2.6
October	2,678	10.5	37.5	37.7	4,455	4.3	7,133	6.5	7,112	7.7
November	2,671	-0.3	37.1	36.8	4,533	1.8	7,205	1.0	7,291	2.5
December	2,715	1.7	36.7	36.7	4,677	3.2	7,392	2.6	7,407	1.6

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

<sup>b</sup> Including demand deposits in the Israel Bank of Agriculture and in branches of Israeli banks operating in the administered areas.

1973. On the other hand, the ratio of demand deposits to the economy's transactions declined, suggesting a change in the pattern of liquid asset holdings.

## 5. OTHER LIQUID ASSETS OF THE PUBLIC<sup>19</sup>

In 1973 other liquid assets held by the public—time deposits in Israeli and foreign currency, the Short-Term Loan, and approved saving schemes—grew by 16.1 percent, compared with 19.7 percent in 1972. The component items displayed a differential development: IL time deposits and the Short-Term Loan dropped below their end-1972 levels, while approved saving scheme and foreign currency deposits moved up at a much stronger pace than in 1972 (see Table XIII-8).

Together with the heavier purchase of value-linked bonds in 1973, this indicates a greatly increased preference for linked assets in the year reviewed, for reasons already explained. The first signs of this development appeared in 1972, but it assumed significant proportions in the following year, especially in December.

### (a) *Pazak and Tamam accounts*

Pazak and Tamam accounts of personal restitution recipients swelled by IL 1,050 million, or 28.4 percent, in 1973, as against IL 465 million (14.9 percent) the year before. Other foreign currency accounts of the public expanded by IL 382 million, as contrasted with IL 134 million in 1972.

The figures on Pazak and Tamam reflect the volume and composition of restitution receipts on the one hand and the readiness to convert the various types of receipts on the other. A glance at Table XIII-9 shows that from the standpoint of the volume of restitution receipts the year reviewed resembled 1972, but as regards the weight of exchange rate differentials in the total increment it was more akin to 1971, when the Israeli pound was devalued: (In 1972 exchange rate and linkage differentials did not add up to a significant sum.)

Taking 1973 as a whole, the rate of conversion of Pazak and Tamam deposits was low compared with previous years. To be sure, of the total potential increase in the accounts 42 percent was converted in 1973, compared with 34 percent in 1972; however, it should be recalled that the 1971 devaluation came in August, too late for depositors to adjust their portfolios by year's end. In 1972 the rate of conversion reached a formidable 66 percent, both because of the low weight of exchange rate differentials in the incremental balances and because of the postdevaluation reshuffling of portfolios. In 1971

<sup>19</sup> The definition of several categories of assets was revised somewhat in 1973 owing to a change in the banks' monthly report forms. In Table XIII-9' the data for 1972 are presented according to both the old and new definitions.

**Table XIII-8**  
**OTHER LIQUID ASSETS HELD BY THE PUBLIC, 1971-73<sup>a</sup>**  
 (IL million)

End of period	Time deposits in Israeli currency	Short-Term Loan <sup>b</sup>	Total unlinked interest-bearing assets (1+2)	Approved saving schemes	Deposits against liabilities	Deposits linked to foreign currencies (Pazak restitution)	Pazak nonrestitution and foreign currency deposits other than Tamam	Tamam foreign currency deposits	Grand total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1971	2,859	677	3,536	1,483	16	2,984		1,166	9,185
1972									
Original series	3,746	711	4,457	1,752	29	3,359		1,391	10,988
New series <sup>c</sup>	3,874	711	4,585	1,779	83	2,311	1,010	1,391	11,159
1973	3,838	389	4,227	2,495	88	2,961	1,392	1,791	12,954
January	3,888	658	4,546	1,799	98	2,338	1,016	1,404	11,201
February	3,903	642	4,545	1,818	78	2,620	1,090	1,556	11,707
March	3,804	601	4,405	1,851	92	2,689	1,117	1,595	11,749
April	3,779	673	4,452	1,877	83	2,678	1,145	1,606	11,841
May	3,804	692	4,496	1,950	83	2,755	1,181	1,662	12,127
June	3,800	687	4,487	2,053	71	3,114	1,225	1,860	12,810
July	3,795	711	4,506	2,137	87	3,222	1,334	1,924	13,210
August	3,805	735	4,540	2,227	84	3,107	1,273	1,846	13,077
September	3,786	705	4,491	2,302	92	3,176	1,335	1,917	13,313
October	3,744	633	4,377	2,337	90	3,180	1,326	1,907	13,217
November	3,792	520	4,312	2,386	86	3,005	1,343	1,806	12,938
December	3,838	389	4,227	2,495	88	2,961	1,392	1,791	12,954

<sup>a</sup> Excluding deposits of the public earmarked for loans, most of which belong to social insurance funds and financial institutions.

<sup>b</sup> Excluding certificates held by the banks. Previous *Annual Reports* presented the total balance held by the public and banks, but because of the underwriting agreement (January 18, 1973) the banks' holdings increased to such an extent as to make it necessary to alter the series.

<sup>c</sup> See note <sup>c</sup> to Table XIII-1.

and 1972 combined the share of Pazak and Tamam funds converted was 52 percent, which is higher than the 42 percent recorded for 1973, even though the weight of exchange rate and linkage differentials was fairly close in these two periods (33 percent in 1972 as against 28 percent in 1971 and 1972).

The relatively low rate of conversion in 1973 reflected a behavioral change during the year. Between January and September Pazak and Tamam accounts appreciated greatly as a result of the jump in the value of the German mark,<sup>20</sup> and the rate of conversion in that period was low. In the latter part of the year, when it became clear that the DM was hardly likely to appreciate further (and in fact was expected to lose some ground), and after a certain period of adjustment, the volume of conversions swelled.

In the first two months of 1974, when expectations of the devaluation of the IL sharpened noticeably, conversions fell off. The public was apparently anticipating a decline in the value of the DM—i.e. the strengthening of the Israeli pound as against the DM and the devaluation of the IL in relation to the dollar. The expected rate of devaluation in relation to the dollar was presumably higher than the expected rate of revaluation in relation to the DM; as a result, the beginning of 1974 saw an accelerated growth of Pazak and Tamam accounts.

#### (b) *Unlinked liquid assets*

For the first time since the money market began to expand rapidly in the early 1960s, time deposits and Short-Term Loan holdings contracted in the year reviewed. The 7.8 percent drop in these two asset categories followed a deceleration of the uptrend begun in the second half of 1971. During the first nine months of 1973 the balance inched down 2.1 percent; from the end of September to the end of December the downtrend grew more pronounced and reached 5.9 percent; in the first quarter of 1974 the level fell by an additional 8.4 percent, according to provisional data.

The reasons for this development are the acceleration of inflation since the second half of 1970, which has not been accompanied by the upping of the interest rate on these assets, and the availability of value-linked assets promising an attractive real yield.

Given the intensification of inflation in 1973, the growth of linked asset holdings is not surprising; but what is noteworthy is the fairly lagged response of owners of unlinked assets to this development.

In the 1972 *Annual Report* the belated response was attributed to the fact that unlinked assets, aside from being a medium-term savings medium for

<sup>20</sup> The mark continued to rise until the beginning of July, but in August it turned downward. However, this may be regarded more as a correction of the steep increase in June and July, and the beginning of the precipitate decline may be attributed to November.

certain sections of the population, constituted a convenient substitute for money for certain other groups—mainly business firms, institutions, and other organizations. A breakdown of deposits by size showed that in 1972 the growth of unlinked assets was the result of two divergent developments: one, the sagging growth of household savings (small deposits) and the shift to assets maintaining their real value; and second, the moving of funds out of demand deposit accounts (large deposits).

Table XIII-9

ESTIMATED CONVERSION OF PAZAK AND TAMAM FUNDS  
BY RESTITUTION RECIPIENTS, 1971-73<sup>a</sup>

(IL million)

	Resti- tution receipts	Interest on Pzak and Tamam accounts	Ex- change rate differ- entials	Total potential increase (1+2+3)	Actual increase	Amount converted into IL (4-5)	Rate of conversion	
							A <sup>b</sup> (6 ÷ 4)	B <sup>c</sup> (6 ÷ [1+2])
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1971	854	129	783	1,765	1,160	605	34	62
1972	1,105	181	82	1,368	465	902	66	70
1973	1,102	238	665	2,005	1,164	843	42	63
January	55	17	17	89	32	57	64	79
February	83	22	364	469	450	20	4	19
March	101	22	91	213	138	75	35	61
April	102	18	-8	113	-9	122	108	101
May	85	20	80	186	90	96	52	91
June	96	19	390	504	421	83	17	73
July	90	17	498	605	495	111	18	103
August	94	18	-365	-253	-351	98	..	88
September	106	17	68	192	152	40	21	33
October	87	27	-34	79	-1	80	101	70
November	102	17	-338	-219	-248	29	..	24
December	102	23	-98	28	-5	33	118	26

<sup>a</sup> The data relate to Pzak restitution funds and Tamam, but not to other Pzak accounts.

<sup>b</sup> This calculation assumes that the differentials arising from the revaluation of the German mark are treated in the same manner as restitution receipts and the interest on Pzak and Tamam accounts.

<sup>c</sup> This calculation assumes that the differentials are accumulated in full; in other words, the funds converted originated solely in restitution receipts and the interest on Pzak and Tamam accounts.

Partial data on the size distribution of time deposits at the end of 1973 show that the decline in the balance of such deposits was not uniformly spread over the various groups. The biggest fall was in small deposits; by contrast, large deposits decreased very slightly and in fact may even have risen fractionally. The aggravation of inflation in the first nine months of the year induced a flight from savings; but as against this the yields on the Short-Term Loan and time deposits rose somewhat, accentuating the shift away from demand deposits.

The intensity of the inflationary expectations eventually proved decisive, and the balance of unlinked assets drifted downward until September 1973, while the money supply continued to expand and approved saving scheme deposits and index-linked bond purchases accelerated strongly.

Since October the decline in unlinked assets has gathered momentum, with the sharpest drop being in the Short-Term Loan; most of the funds have shifted to index-linked assets, and in the case of businesses also to the purchase of foreign currency. Demand deposits reveal a similar development since December and especially January 1974. This lends weight to what was said above about the interchangeability, at least from the standpoint of private business, institutions, and organizations, between time deposits and the Short-Term Loan on the one hand and demand deposits on the other.

Although in 1973 demand for unlinked interest-bearing assets weakened, the movement of the two component items is of interest. From the end of December 1972 to the end of September 1973 Short-Term Loan holdings of the public dropped by IL 6 million, while time deposits plummeted IL 88 million. This was an exceptional development, for in every other year since 1968, when the Bank of Israel began to conduct an absorptive policy after the previous year's recession, time deposits and bank-negotiated bill credits rose faster than the Short-Term Loan. The preference displayed by the public for time deposits was not necessarily due to any improvement in yield, but in many cases is explained by the energetic advertising campaign of the banks aimed at plugging time deposits, which in recent years have been their chief source of loanable funds.

The stability of the Short-Term Loan holdings until September 1973, a period which saw the contraction of time deposits, can be credited to the underwriting agreement concluded between the Bank of Israel and the commercial banks in January 1973, under which the banks committed themselves to increase the balance of the loan to IL 850 million by November 1973. The monetary considerations behind this agreement were described in section 2; here it should be noted that in certain respects it gave the Short-Term Loan an edge over time deposits, for the first time since its issue began. The banks were ready, when their deficiencies had sunk to their trough, to sell the paper to major clients at a price assuring the latter a 15 percent return. From the time when this agreement went into effect until its abrogation in the first

week of the war, the banks were in a liquidity deficiency position most of the time, and sales of the Short-Term Loan reduced the deficiencies and the penalty payments to a greater extent than the receipt of time deposits.<sup>21</sup>

To stimulate the sale of the Short-Term Loan the banks gave large buyers a discount in March and April, thereby making the yield more attractive. In a sense the underwriting agreement made Israel's money market a little more akin to those in developed economies, for after it went into effect the sale of the loan to the public resembled that in developed money markets, where new issues are sold by auction. While sales of this loan were made in accordance with the underwriting agreement, once the paper came into the banks' possession its resale was governed by considerations similar to those displayed by financial institutions abroad, which purchase bonds by auction.

The underwriting agreement was terminated in the second week of October, and from that date until the end of March 1974 the balance of the loan plunged by IL 600 million, compared with less than IL 100 million in the case of time deposits. At the end of March 1974 the interest on deposits for six months or more was raised by 1.5 points, bringing it up to 14.5–15 percent in the large banks.

### (c) *Approved saving schemes*

The year reviewed saw a turnabout in the development of approved saving schemes with the introduction of a new plan in May. Accumulation in such schemes totalled IL 676 million in 1973,<sup>22</sup> up 38 percent from the previous year; this compares with increases of 19.1 percent in 1971 and 18.1 percent in 1972. The better terms offered by the new plan were undoubtedly the main reason for the much greater accumulation in the year reviewed, but the balances began to rise in the first four months as part of the general shift to linked assets. During this period saving scheme deposits expanded by IL 125 million, compared with less than IL 75 million in the corresponding period of 1972 and 1971.

The reasons for the relatively sluggish growth in the three preceding years were discussed at length in previous *Annual Reports*; in the main it was connected with the greater attraction of other index-linked savings media—linked bonds and bank-administered provident funds. The saving schemes were inferior to bonds, for the yield on deposits held for the full five-year period

<sup>21</sup> When the sale of the Short-Term Loan comes in place of time deposits, it reduces the banks' required liquid asset cover by 25 percent of the amount of the sale. Because of the magnitude and duration of the liquidity deficiencies during most of the period between January and September, sales of this paper greatly reduced the banks' expenses.

<sup>22</sup> The increase in approved saving schemes amounted to IL 716 million, of which some IL 40 million represented the payment of an initial 10 percent premium to depositors in the new scheme (the premium is credited to the savers' accounts).

amounted to 4 percent a year with interest unlinked (the principle was linked); in addition, the withdrawal of the deposit before the terminal date resulted in a substantial yield loss. It should be noted that the higher the rate of inflation, the greater are the two disadvantages of saving schemes in comparison with linked bonds. First is the increase in the real loss sustained by those withdrawing their deposits before the terminal date; and secondly, since the interest on saving schemes is unlinked, the faster prices rise the more its real value is impaired.<sup>23</sup>

The new plan introduced in May features two major innovations: a higher return due to the payment of an initial 10 percent premium, which is equivalent to a 2 percent increase in index-linked interest for those holding their deposit for the full five-year period,<sup>24</sup> and a loss of liquidity because of the inability to withdraw the deposit before two years and the stiffening of the price of withdrawing it after this period.

While this improvement in the return considerably narrowed the gap between it and bond yields evident until February 1974, in 1973 bonds still had an edge over saving schemes. To demonstrate this, it should be noted that even if prices rise by only 15 percent p.a. over the next five years, the return on saving schemes will still be lower than that on an investment in index-linked bonds.

As to the loss of liquidity from the savers' viewpoint, in the old schemes deposits could be withdrawn before the terminal date but at the price of forgoing linkage differentials during the first two years. If the deposit was withdrawn during the third year the saver received half the linkage differentials, and if in the fourth year he was entitled to three-fourths. At a time of strong inflation, this has constituted a serious deterrent to the premature withdrawal of deposits.<sup>25</sup> In the new plan the saver cannot withdraw his deposit during the first two years, so that it is in effect totally illiquid during this period. The 10 percent premium (90 percent of which is paid by the Treasury) is also intended to discourage premature withdrawals, as only those holding their deposit for the full period actually receive it. This means that the price of premature withdrawal rises the closer the terminal date.

The launching of the new plan in May was accompanied by a vigorous advertising campaign. The amount accumulated in this plan and in a subsequent slightly different version came to IL 400 million by the end of the

<sup>23</sup> To illustrate this, it should be noted that if during the five-year period of the deposit prices rise at an annual rate of 15 percent, the unlinked 4 percent interest is actually equivalent to only 2 percent on a linked basis.

<sup>24</sup> This is in addition to unlinked tax-exempt interest of 4 percent which the depositor receives at the end of the five-year period.

<sup>25</sup> The withdrawal of deposits before the terminal date is a fairly widespread phenomenon—Bank of Israel data for 1971 showed that fully half of all deposits were withdrawn before the end of four years.

year (this does not include the premium credited to savers' accounts). The improvement of the return on approved saving schemes was long overdue, for it was unreasonable to offer savers familiar with the workings of the capital market a plan that was less liquid and offered a much lower return than linked bonds. But it is doubtful whether the existing profit margins on the older saving schemes were wide enough to enable the banks to increase the return to savers, especially as this has led to the swelling of deposits.

It is obvious that those joining the approved saving schemes in 1973, both before and after May, were not sophisticated savers familiar with the workings of the bond market. Rather they were probably drawn from the ranks of those who in the past had been accustomed to place their savings in time deposit accounts or other unlinked assets. The mounting inflationary expectations led, quite belatedly, to a search for media capable of protecting the real value of savings. Those who are not very familiar with the various alternatives naturally tend to accept the advice of bank officials, and the latter of course recommend switching to the saving schemes run by their own institutions, especially as the reference is generally to small monthly deposits for which this savings instrument is very suitable.

In conclusion, the influence of the change in bond yields in February 1974 must be noted. The skidding of the real yields on such paper while the return on saving schemes held steady resulted, for the first time, in a marked preference for the latter over bonds. In 1974 a sustained rapid growth of saving scheme accounts may therefore be expected; in the first quarter alone such deposits rose by almost IL 100 million a month.

## 6. SOURCES OF MONETARY EXPANSION

The first nine months of 1973 saw a slackening of the uptrend in the money base, money supply, time deposits, and the Short-Term Loan compared with the same period the year before, while in the final quarter the money base and the money supply expanded more rapidly than in the last three months of 1972.

In section 2 we discussed at length the implications of monetary developments in the various subperiods of the year reviewed. Here we shall describe the factors behind these developments. During the first nine months of 1973 the laggard growth of the money base was the main cause of the slackening of monetary expansion. The component undergoing the most striking change was the sale of foreign currency by the private sector, which fell from IL 2,054 million in 1972 to IL 1,212 million in the year reviewed.<sup>26</sup> By contrast, the Government's budgetary operations resulted in a small liquidity infusion (IL 6 million), whereas in the corresponding period in 1972 it had absorbed

<sup>26</sup> For a definition of foreign currency sales see section 6 (c) below.

**Table XIII-10**  
**LIQUID ASSETS OF THE PUBLIC, BY SOURCE AND COMPONENT, 1971-73**  
 (IL million)

End of period	1971	1972		1973	Percent annual increase or decrease (-)	
		Original series	New series		1972	1971
<b>A. Sources</b>						
Bank of Israel						
Foreign currency assets, net	2,299	4,689	4,689	7,398	104.0	57.7
Credit to the Govt., net	5,113	4,565	4,565	3,825	-10.8	-16.2
Rediscounts						
To the Jewish Agency	125	415	415	354	232.0	-14.7
To the public (incl. local and foreign currency loans) <sup>a</sup>	754	723	712	1,248	-4.1	75.2
Total	<b>8,291</b>	<b>10,392</b>	<b>10,381</b>	<b>12,825</b>	<b>25.3</b>	<b>23.5</b>
Banking institutions						
Foreign currency liabilities, net	-428	-623	-669	-1,340	-45.6	-100.2
Credit to the Govt. in IL, net	688	857	894	1,237	24.6	38.4
Credit to the public						
Nondirected credit in IL	3,177	3,737	3,631	4,277	17.6	17.8
Nondirected foreign currency credit and directed credit in local and foreign currency <sup>b</sup>	1,772	2,329	2,352	3,446	31.5	46.5
Total	<b>5,209</b>	<b>6,300</b>	<b>6,208</b>	<b>7,620</b>	<b>20.9</b>	<b>22.7</b>
Other factors, net	26	-118	157	-99	.	.
Total sources	<b>13,526</b>	<b>16,574</b>	<b>16,746</b>	<b>20,346</b>	<b>22.5</b>	<b>21.5</b>
<b>B. Components</b>						
Money supply	4,341	5,587	5,587	7,392	28.7	32.3
Less-liquid deposits in local and foreign currency	8,508	10,276	10,448	12,565	20.8	20.3
Short-Term Loan held by the public <sup>c</sup>	677	711	711	389	5.0	-45.3
Total	<b>13,526</b>	<b>16,574</b>	<b>16,746</b>	<b>20,346</b>	<b>22.5</b>	<b>21.5</b>

<sup>a</sup> Revised data; excluding credit to the banks.

<sup>b</sup> Total directed credit granted through the directed credit funds and other directed credit, less the Bank of Israel's participation in local and foreign currency.

<sup>c</sup> Excludes certificates held by the banks.

IL 325 million. In other words, the combined effect of the two leading exogenous factors in the liquidity infusion was less expansionary during the first nine months of 1973 than in the same period the year before. Furthermore, in 1972 the Bank of Israel took much stronger action under its credit policy to reduce the money base. During the first nine months the amount of money absorbed through the structural change in the export credit funds was IL 64 million less than the amount of Israeli currency credit infused into the economy as a result of the natural growth of the funds. During the same months in 1973 there was a net absorption of IL 80 million from this source. On the other hand, the banks' open-market operations mopped up a similar sum in both years—about IL 85 million during the first nine months.

As a result of these changes, the money base broadly defined rose 16 percent between January and September 1973, compared with 27 percent in the corresponding period of 1972.

As opposed to the decelerated growth of the money base, the money supply multiplier increased during the first nine months of 1973. The marginal multiplier (the ratio between the growth of the money supply and that of the money base) went up from 0.87 in the first three quarters of 1972 to 1.26 in the year reviewed. The increase stemmed primarily from two sources: (a) after expanding rapidly in 1972, time deposits failed to increase in 1973; (b) during the first nine months of 1973 bank credit to the public was stepped up, leading to a IL 176 million depletion of the banks' free reserves, compared with a mild IL 26 million the year before. The raising of the liquidity ratios on time deposits at the beginning of 1973 sharply depressed the formal multiplier, but the effect of this step was counterbalanced by the shrinkage of the banks' liquidity reserves.

As a result of the various moves made by the Treasury and the Bank of Israel, the growth of the money base accelerated in the final quarter of 1973 to IL 700 million, or 11 percent. On the other hand, sales of foreign currency by the private sector came to a halt, and in fact there was even an absorption of liquidity from this source. The appreciable expansion of the money base led to a weakening of demand for bank credit, with a consequent reduction of the banks' liquidity deficiencies, as indicated by the drop in the money supply multiplier.

#### (a) *Bank credit to the public*

Like the other monetary variables, bank credit to the public developed differently in the pre- and postwar periods. During the first nine months of 1973 the volume of such credit was stepped up at a faster rate than in the corresponding period the year before—23.2 as against 9.5 percent (see Table XIII-11).

In the final quarter nondirected credit expanded by IL 581 million, or 16

**Table XIII-11**  
**OUTSTANDING CREDIT GRANTED TO THE PUBLIC BY THE BANKING SYSTEM, 1971-73<sup>a</sup>**  
 (IL million)

	Nondirected credit in Israeli currency	Directed Bank of Israel credit	Foreign currency credit from banking institutions other than through the directed credit funds <sup>b</sup>	Total bank credit to the public (1+2+3)	Credit from earmarked nongovern- mental deposits	Credit against Government deposits	Credit from earmarked Government deposits
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1971	3,177	2,019	507	5,703	2,137	144	978
1972							
Original series	3,737	2,352	700	6,789	306	164	1,101
New series	3,631	2,290	774	6,695	2,615	156	1,172
1973	4,277	3,150	1,544	8,971	3,677	283	1,522
January	3,780	2,334	774	6,888	2,741	151	1,163
February	3,900	2,325	840	7,065	2,774	166	1,193
March	4,159	2,362	833	7,354	2,873	213	1,175
April	4,096	2,448	866	7,410	2,905	212	1,169
May	4,023	2,463	896	7,382	3,005	208	1,188
June	4,092	2,631	896	7,619	3,027	203	1,240
July	4,204	2,820	940	7,964	3,096	196	1,268
August	4,089	3,002	972	8,063	3,187	228	1,302
September	4,212	3,024	1,012	8,248	3,254	270	3,157
October <sup>b</sup>	4,152	3,014	1,146	8,312			
November <sup>b</sup>	3,972	3,050	1,357	8,379			
December <sup>c</sup>	4,227	3,150	1,544	8,971	3,677	283	1,522

<sup>a</sup> The new series of credit data is based on the monthly report form used by banks since January 1974, as a result of which several definitions were changed. Linkage differentials are not included in the data.

<sup>b</sup> Provisional data.

<sup>c</sup> Excludes bank credit extended to purchasers of the Voluntary War Loan. The stopgap credit granted to ensure normal economic activity during the emergency (the balance of which stood at IL 109 million on December 31, 1973) and all other wartime emergency credits are included in the figures in column (2).

percent, compared with 9.5 percent in the last three months of 1972. The volume of directed credit provided by the Bank of Israel, mostly through the various export and working capital funds, increased in the first nine months of 1973 by IL 727 million, or 31.5 percent, as against only 6.1 percent the year before. About half the additional finance went to the diamond industry; excluding this sum, the increase came to IL 354 million, or 20 percent.

Foreign currency credit granted by the banks (on the strength of permits issued by the Treasury's Foreign Exchange Department) and by the Bank of Israel rose by an appreciable IL 238 million, or 30.8 percent. The bulk of such credit goes to shipping and fuel companies and for financing certain types of imports.

The accelerated uptrend in nondirected bank credit in 1973 was connected first and foremost with the decreased supply of liquidity due to the external infusions. The development of such credit in the course of the year (including the fourth quarter) mitigated the effects of the sharp swings in the money base. In the first quarter there was a rise of IL 528 million, or 14.5 percent; this was accompanied by a large Government absorption, which whittled the money base down by a substantial 5.4 percent. The seasonal pattern of Treasury disbursements led to a brisk demand for nondirected credit, and the banks' response to this demand kept the money supply from shrinking in the first quarter. The banks were ready to meet the heavy demand for credit even at the price of incurring sizable liquidity deficiencies, as they expected the Treasury to resume its infusion of liquidity at the beginning of fiscal 1973/74—an expectation which did in fact materialize.

Following the seasonal injection of liquidity by the Treasury and that engendered by the sale of foreign currency in April and May, the balance of nondirected credit fell in the second quarter. This was connected with the repayment of part of the seasonal incremental credit supplied in the first quarter of the year, as well as with the banks' desire to reduce the large liquidity deficiencies created during this quarter.

The lively demand for credit reasserted itself at the beginning of the third quarter, initially in connection with the share issues floated in the first half of July, and subsequently in anticipation of the imposition of credit restrictions by the Bank of Israel and perhaps even the raising of its price. On June 18 a 100 percent liquidity ratio was clamped on incremental nondirected credit. This not only reduced the banks' loanable funds available for stepping up nondirected credit, but it also gave them an incentive to cut their outstanding credit balances and thus their liquidity deficiencies as well (the new liquidity requirement was terminated after the outbreak of war).

The balance of nondirected credit declined between the middle of July and the end of August, but in September it again turned upward because of the usual strong demand during the High Holiday season. Toward the end of the quarter the price of bank credit was raised by one point to 17.5 percent. During

the first nine months of the year it apparently went up by more than this, for the interest charged on excessive overdrafts was hiked substantially.

During the first nine months of 1973, even more than in previous years, it was difficult to determine the relative contribution of demand and supply factors to the changes in the volume of nondirected credit and its price. As regards supply, the brisk demand for credit in the first quarter of the year did not arouse any undue concern in the banking community, for this was a usual seasonal phenomenon (although its proportions in 1973 were greater than in the past). Problems cropped up in the second quarter, when it transpired that the money base was not expanding as rapidly as expected and time deposits ceased to grow. During this period the banks refrained from raising debitory interest rates, chiefly because of public pressure. Their efforts were directed mainly to reducing credit allocations to clients so as to pare their sizable liquidity deficiencies. Most banks in fact did not expand nondirected credit between the end of March and the end of September, and the majority succeeded in wiping out their enormous liquidity deficiencies.

The demand for nondirected credit did not generate any undue pressure after the first quarter of the year. The modest dimensions of such demand is attributable to the relatively rapid expansion of short-term directed credit on the one hand and the big increase in medium-term credit relative to the volume of investments on the other (see Chapter XIV). In certain branches of the economy credit from customers rose as a result of a larger volume of advance payments by households.<sup>27</sup>

Despite the various factors moderating the demand for nondirected credit in 1973, it is difficult to understand why it stabilized in April, when real interest was of a negative magnitude. In the twelve months preceding the war the general price level moved up by an accelerated 22.4 percent, outstripping the rise in the effective debitory rate of interest paid by most borrowers in the economy. To some extent the relatively sluggish growth of such credit can apparently be attributed to supply developments, but it is doubtful whether these can offer a full explanation; it must therefore be assumed that demand factors were also partly responsible.<sup>28</sup>

<sup>27</sup> This applies in particular to manufacturers and dealers in durable consumer goods (such as electric refrigerators and locally assembled cars) who were unable to meet the demand, so that there was a longer delay in deliveries. It apparently applies also to dealers in European and Japanese import brands, since there were expectations of an appreciation of these countries' currencies.

<sup>28</sup> If the decisive factor in the credit expansion during the first nine months of 1973 had been mounting demand, the banks might have been expected to step up the supply by various means involving a smaller price than the effective penalties rates for liquidity deficiencies. Examples of such possible action are the sale of Short-Term Loan certificates from the banks' portfolio to the public at a price ensuring buyers a higher yield throughout the entire period, the hiking of interest rates on time deposits, and the sale of linked bonds from their own portfolios.

A sectoral distribution of nondirected credit shows that between the end of December and the end of June 1973 there was no increase in the amount supplied to industry and agriculture, while that granted to the construction industry rose only slightly. Most of the incremental finance of this type went to local authorities and the trade and service sectors.<sup>29</sup>

In October and November the balance of nondirected credit dropped sharply. This was due on the one hand to the stopgap credits granted by the Bank of Israel during this emergency period, and on the other hand to the large volume of disbursements made by the Accountant General, which greatly reduced the Government's liabilities to its suppliers as well as the latter's recourse to bank credit. Moreover, as part of the policy of infusing liquidity during this period of national emergency, the Accountant General speeded up payments to local authorities, institutions, and others—a step which came on top of the enormously larger Government expenditure in the postwar months. In addition, financial institution data indicate that in the final quarter of 1973 the volume of investment credit granted went up faster than actual capital spending.

Despite the action taken by the Bank of Israel and the Treasury to infuse liquidity into the economy, nondirected credit swelled by more than IL 800 million, or 28 percent, between the end of November 1973 and the end of March 1974 (Wednesday figures). As already mentioned, this can partly be ascribed to the speculative demand engendered by the expectations prevailing at the time.

#### (b) *Credit to the Government*

In 1973 the Bank of Israel's credit transactions with the Government resulted in a liquidity infusion, as contrasted with the previous year's absorption. During the first nine months of 1973 credit to the Government and National Institutions was stepped up by IL 135 million, while the Government injected some IL 25 million; in the same period the year before the Government's budgetary operations siphoned off IL 325 million (see Tables XIII-12 and XIII-4).

The Government's influence on the economy's liquidity (injection or absorption) is defined in this chapter as credit received by the Government and the National Institutions from the Bank of Israel, plus foreign currency sales by the private sector (or minus its purchases).<sup>30</sup> This definition tells us how many pounds the public sector pumped into the economy, but it does not of

<sup>29</sup> A large percentage of the additional credit received by the local authorities consisted of the proceeds of the Employers Loan, which the banks were required to transfer to the Treasury but instead went to finance the local authorities.

<sup>30</sup> The Government's purchase of foreign currency is generally shown net of its IL receipts from the sale of imported foodstuffs to the economy. In other words, the absorptive effect of the food imports is attributed here to the private sector, which consumes the commodities, and not to the Government, which imports them.

Table XIII-12

**CHANGES IN OUTSTANDING CREDIT FROM THE BANKING SYSTEM  
TO THE GOVERNMENT AND NATIONAL INSTITUTIONS, 1971-73**

(IL million)

End of period	From the Bank of Israel			From banking institutions			
	Credit granted to the Govt.	Less: Increase in Govt. and National Institution deposits <sup>a</sup>	Total	Credit granted to the Govt.	Investment in Govt. securities <sup>b</sup>	Less: Increase in Govt. deposits <sup>c</sup>	Total
		(1)					
1971	5,354	241	5,113	162	618	92	688
1972							
Original series	5,203	638	4,565	246	684	73	857
New series	5,203	638	4,565	264	678	48	894
1973	5,661	1,836	3,825	487	823	73	1,237
January	4,946	584	4,362	249	684	29	904
February	4,861	635	4,226	287	647	37	897
March	4,773	905	3,868	260	663	57	866
April	5,223	999	4,224	342	647	68	921
May	5,206	857	4,349	358	643	64	937
June	5,316	679	4,637	339	636	63	912
July	5,249	662	4,587	380	629	63	946
August	5,357	704	4,653	404	642	55	991
September	5,402	703	4,699	415	655	30	1,040
December	5,661	1,836	3,825	487	823	73	1,237

NOTE: Publication of the figures for October and November was forbidden because of the national emergency.

<sup>a</sup> Includes the capital of the Bank of Israel and the "other accounts" item in the Bank's balance sheet.

<sup>b</sup> Excludes treasury bills and the banks' Short-Term Loan holdings.

<sup>c</sup> Israeli currency deposits, the Government's participation in the working capital funds, and the difference between Government deposits earmarked for loans to the public and the loans actually extended.

course reflect the effect of the Government's operations on the balance of payments.

Although during the first nine months of 1973 the Government's operations did not generate a liquidity infusion, it should be recalled that part of its incremental receipts from the heavier sale of bonds to the public, while reducing the Government's liquidity by the full amount of the sales, did not reduce the liquidity of the bond purchasers to the same extent. It is therefore questionable whether the entire amount of the bond issue proceeds can be regarded as an absorption in the economic sense, even though from an accounting standpoint it clearly diminished the Government's liquidity infusion.

During the first quarter of the year reviewed (the last quarter of fiscal 1973/74) the Government absorbed IL 574 million; in the second quarter (the first quarter of the new fiscal year) it injected IL 397 million, and in the third quarter IL 202 million. While this seasonal pattern is fairly normal, the quarterly swings were sharper than usual this year.

Between October and December 1973 there was an enormous IL 731 million liquidity infusion, as contrasted with a IL 280 million absorption in the corresponding period the year before. This was due to the deliberate policy of speeding up disbursements and of averting a shortage of liquidity in the economy, to which was later added the impact of the mounting war-induced Government expenditures.

The incremental Government spending engendered a IL 333 million infusion in October 1973, compared with IL 82 million in the previous month, but since November the size of the injection has diminished, for the larger volume of disbursements has been accompanied by an increase in receipts from linked bond sales. In January 1974, when sales of Government bonds to the public reached a record IL 780 million, the Government's absorption amounted to IL 342 million.

The growth of Government and National Institution deposits with the Bank of Israel in December stemmed from the deposit of part of the enormous volume of foreign transfers received by the public sector in the wake of the war. During the first nine months of 1973 bank credit to the Government expanded by IL 151 million (compared with IL 50 million in the first nine months of 1972), while net IL deposits of the Government contracted by IL 18 million (IL 37 million the year before). The growth of approved saving schemes during this period did not augment the banks' holdings of Government bonds, for they preferred to buy bonds issued by their affiliated financial institutions. The expansion of their bond portfolio in the fourth quarter was partly due to the relatively large purchase of IL 98 million of Bank Defense Loan certificates during this quarter, as opposed to IL 62 million worth in the first nine months of the year.

### (c) *Influence of foreign currency assets*

The strong uptrend in the Bank of Israel's net foreign currency assets carried over through 1973, when the increase totalled \$ 645 million, of which \$ 441 million was recorded in the first three quarters of the year and \$ 204 million in the final quarter. Most of this gain was reflected in the foreign exchange reserves held at the Bank of Israel,<sup>31</sup> which expanded by \$ 413 million between

<sup>31</sup> The foreign currency balances held at the Bank of Israel consist of gold, Special Drawing Rights, deposits and other liquid investments of the Bank, less the deposits of foreign banks with the Bank of Israel and that part of the Patach deposits that is redeposited with it.

**Table XIII-13**  
**FOREIGN CURRENCY ASSETS AND LIABILITIES OF THE BANKING SYSTEM, 1971-73**  
 (IL million)

End of period	Bank of Israel				Banking institutions			
	Foreign currency assets	Foreign currency liabilities		Net assets (1-2-3)	Foreign currency assets <sup>c</sup>	Foreign currency liabilities		Net assets (5-6-7)
		Patach deposits <sup>a</sup>	Other liabilities <sup>b</sup>			Patach deposits and blocked accounts <sup>d</sup>	Other liabilities <sup>e</sup>	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
1971	3,355	614	442	2,299	3,343	1,824	1,947	-429
1972								
Original series	5,718	657	373	4,689	5,326	2,499	3,450	-623
New series <sup>f</sup>	5,718	657	373	4,689	5,379	2,515	3,533	-669
1973	8,099	473	228	7,398	7,117	3,823	4,634	-1,340
January	5,813	645	370	4,798	5,007	2,504	3,231	-728
February	6,427	696	376	5,355	5,128	2,466	3,303	-641
March	6,781	704	873	5,699	5,522	2,507	3,793	-778
April	6,683	719	250	5,714	5,516	2,595	3,790	-869
May	6,739	697	251	5,791	5,576	2,729	3,689	-842
June	6,989	694	245	6,050	6,297	2,851	4,245	-799
July	7,588	712	250	6,626	6,498	2,965	4,290	-757
August	7,255	684	252	6,319	7,241	3,065	5,066	-890
September	7,300	495	262	6,543	7,548	3,391	5,057	-900
December	8,099	473	228	7,398	7,117	3,823	4,634	-1,340

NOTE: Publication of the figures for October and November was forbidden because of the emergency.

<sup>a</sup> Nonresidents' deposits redeposited by the banking institutions with the Bank of Israel.

<sup>b</sup> Including deposits with foreign banks and Israeli currency deposits to the credit of the International Monetary Fund in connection with drawings on the first credit tranche. Since 1970 also includes the IMF allocation of Special Drawing Rights to the Bank of Israel.

<sup>c</sup> Mainly loans to and deposits with foreign banks; excludes domestic credit in foreign currency.

<sup>d</sup> Nonresidents' deposits and blocked accounts (Pahab).

<sup>e</sup> Mainly deposits and loans from foreign banks, less net foreign currency loans to the Government.

<sup>f</sup> See note <sup>c</sup> to Table XIII-1.

January and September and by an additional \$ 214 million in the last quarter, bringing the level up to \$ 1,697 million.

The growth of foreign currency asset holdings during the first nine months of 1973 was due primarily to the appreciation of the principal European currencies, in which a fairly large percentage of the assets are invested. Of the \$ 413 million increment, \$ 268 million represented foreign currency valuation adjustments, while only \$ 171 million stemmed from balance of payments developments. In the corresponding period of the previous year net holdings expanded by \$ 463 million, with foreign currency valuation adjustments accounting for only a small fraction thereof. This reflects, of course, a deterioration in the country's goods and services account during the first nine months of 1973, which was not accompanied by a corresponding increase in capital imports.

In the final quarter of 1973 European currencies lost ground, shaving off \$ 114 million from the Bank of Israel's foreign currency asset holdings. In other words, were it not for the effect of the exchange rate changes the Bank's holdings would have risen by a staggering \$ 317 million during this period. This is explained by the enormously larger inflow of foreign currency transfers and the contraction of imports during this quarter owing to the disruption of economic activity. But in December, and especially in the first quarter of 1974, when devaluation expectations grew stronger, the public stepped up its purchase of foreign currency from the Bank of Israel, with the result that foreign exchange reserves failed to expand, in contrast to the usual seasonal pattern.

The commercial banks reported a rapid expansion of foreign currency assets and liabilities in the first nine months of 1973, with the growth of credit from overseas banks and of Patach deposits being accompanied by an increase in Israeli bank deposits abroad. This trend came to a halt in the final quarter, when the volume of arbitrage transactions fell off noticeably owing to the uncertainty prevailing in the world money market.

As already mentioned, an appreciable share of the incremental foreign currency resources of the central bank was used for granting foreign currency credit to Israeli clients other than through the export funds, and to a certain extent also for financing the diamond industry (this is not reflected by the data in Table XIII-12).