

CHAPTER XVII

MONEY SUPPLY, CREDIT, AND THE BANKING INSTITUTIONS

1. MAIN DEVELOPMENTS

From the aspect of the components of the external liquidity infusions, monetary developments in 1975 resembled those in the previous year, but as regards their impact on the money market there was a conspicuous change in the volume of Israeli currency credit and in the rates of interest thereon. During the year the public sector and the Bank of Israel pumped considerable liquidity into the economy, but because of the large-scale purchase of foreign currency by the private sector in the wake of the widening balance of payments deficit and a change in the public's expectations, money became a little tighter this year. This was reflected by the contraction of real money holdings and nondirected credit and a steep rise in interest rates.

Most of the demand for foreign currency for buying financial assets and building up stocks of raw materials and finished products came from those engaging in foreign trade, whereas the upswing in interest rates affected the entire economy, even households. Consequently, monetary developments this year had a disparate effect on the various sectors of the economy.

As stated, the monetary picture was dominated this year by developments connected with government and National Institution operations and private sector purchases of foreign currency. These had severe implications,¹ which strongly influenced the principal monetary

1. The "monetary implications" of the public sector's operations and the private sector's foreign currency transactions refer to their effect on the money base. We distinguish between "monetary implications" and "monetary policy", since the former is the outcome of action in other areas, whereas monetary policy is intended to directly influence the prevailing situation.

variables. The public sector pumped IL5.5 billion of net liquidity into the economy in the course of the year, the supply of directed credit and other payments by the Bank of Israel accounted for another IL1.5 billion, and if we add the approximately IL1.5 billion growth of the banks' liquidity deficiencies,² the total injection came to IL8.5 billion, which exceeded the money base at the beginning of the year. As opposed to these expansionary developments, the private sector's foreign currency purchases siphoned off about IL6.5 billion, so that the net external infusion in 1975 was only about IL2 billion (including the banks' liquid asset shortfalls). In 1974 the public sector and the Bank of Israel had put IL6.2 billion into the economy, while private sector foreign currency purchases had pulled out IL5.1 billion.

As mentioned, the most salient feature of the monetary scene in the year reviewed was the potent monetary implications of the government's and public's economic activity. These exceeded anything in the past (save for 1974), from the aspect of both their absolute magnitude and relative to what the monetary authorities could cope with with the tools available to them; it is doubtful if more refined tools would have been of any avail (see the section on monetary developments during the year).

Despite the foreign currency control apparatus, the private sector has many ways of including in its portfolio of monetary and real assets items involving foreign currency: the advancing of debt repayments abroad, utilization of the right to repurchase foreign currency by households and firms transferring foreign currency, the buildup of raw material stocks, delaying the transfer of export proceeds, etc. The investment decisions of households and business concerns therefore have significance not only for the optimal composition of their investment portfolio, but also for the level of the economy's foreign exchange reserves. Hence an expansionary monetary situation is likely to influence not only the volume of real (i.e. nonfinancial) activity and the price level, but the demand for foreign currency as well. Given Israel's system of fixed exchange rates, such demand will have an immediate and full impact on the country's foreign exchange reserves.³

The quantity of money was 31 percent higher than its annual average level in 1974, but since prices advanced at a 39 percent average rate, the money supply contracted 6 percent

2. This is the figure for the entire year, but it should be noted that the deficiency grew by IL500 million in December alone. On an annual average it came to IL700 million. Although the banks' liquidity deficiencies are not part of the money base as conventionally defined, since their monetary-economic impact is analogous to that of a liquidity injection, they are included in the discussion.

3. As contrasted with an economy with a floating exchange rate, where variations in the demand for foreign currency mainly affect the rate of exchange and not the volume of reserves.

in real terms. Examination of the path traced by the money supply over the year reveals a similar picture, but the decline in December levels was only 1.5 percent. The main reason for the downturn apparently lay in the steep rise in interest rates.

The contraction of real money balances is also reflected in the data on turnover velocity, as variously measured. A glance at Table XVII-2 shows that the velocity of the money supply and of total unlinked liquid assets increased during 1975, continuing the trend of the two preceding years. Compared with 1972, the rise in the case of money ranged from 23 to 33 percent, and that of all unlinked liquid assets from 60 to 75 percent. This notable change in the past few years was partly due to a more economical use of money because of the accelerating inflation; that the trend carried over through 1975 despite the weakening of inflation is mainly explained by money market developments in the wake of the external drain generated by the purchase of foreign currency. These developments were chiefly a jump in real debitory interest rates and a milder growth of credit compared with 1974.

Total bank credit in Israeli currency rose 34 percent above its average level last year to reach IL11.4 billion. But since prices advanced faster than this, there was a real decline of 4 percent, about the same as in the previous year. Foreign currency credit spurted at a 39 percent average rate in dollar terms. But if the financing of fuel imports is excluded, the real rise was fairly sluggish throughout the entire year, and in the second half the level even turned downward. IL credit linked to the exchange rate expanded 24 percent in dollar terms, as opposed to 8 percent last year. The growth of these two categories mitigated the impact of the real decline in IL credit.

Directed credit, which was introduced in the 1950s to ensure the availability of financing for high-priority purposes during a period of credit freeze, has steadily come to have (especially in the last few years) a substantial subsidy element because of the widening differential between the interest on this type of credit and the going free-market rates. Since the subsidization of such credit has been accompanied by a sizable monetary expansion and has been confined to a single factor of production (capital), it has led to a wasteful use of such money.

The year reviewed saw a rise in interest rates on the various types of bank credit. That on nondirected credit was hiked by five percentage points or more, bringing up the effective rate to prime borrowers to 30 percent or more;⁴ those who made drawings in

4. The effective rate of 30 percent or more on overdraft facilities consists of the formal rate of interest, commitment fees, and the effect of value-dates and of basing the calculations on a 360-day year. It does not include penalties for drawings in excess of established overdraft limits, which brought the price up to 45 percent or more.

excess of the established overdraft limits⁵ even paid up to 45 percent per annum.⁶ The jacking up of interest on nondirected credit had particular significance, given the noticeable retreat of inflation in 1975; in fact, for the first time in several years the real rates of interest were positive.⁷ It is important to note that the higher interest rates did not affect export production, because of the frequent mini-devaluations and because most of the financing was supplied through various directed credit funds in accordance with government and Bank of Israel directives and was subsidized; it only curtailed activity in the domestic market, which squared with the economic policy objectives. The interest charged by the various directed credit funds supplying working capital in Israeli currency was also raised--by two points-- but remained negative in real terms.

To sum up, these indicators reveal that, despite the large liquidity injection, there was some tightness in the money market this year and that it is explained by the buoyant demand for foreign currency, for the second year running. This was one of the factors depressing the gross national product originating in the business sector.

In earlier years too the Israeli economy had experienced waves of speculative demand for foreign currency, when the public believed that the exchange rate of the IL would be altered in the near future. The contractionary effect on the money base of the sizable acquisition of foreign currency had been of a temporary nature; it would be arrested or reverse direction with the implementation of devaluation or a change in the public's expectations. But in 1975 the policy of creeping devaluation modified the pattern of the public's expectations and hence the demand for foreign currency, even though the probability of a substantial devaluation in the long run remained unchanged. Instead of the public's anticipating large, comparatively infrequent devaluations, this year it knew that numerous mini-devaluations were in the offing. This inevitably resulted in some reshuffling of its portfolio of real and financial assets in favor of items denominated in or linked to foreign currency, and in a much heavier conversion of Israeli currency.⁸

5. According to partial data, about 20 percent of the overdraft facilities in 1975 consisted of drawings in excess of the established limits. The extra interest on such drawings was doubled during the year from 7.5 to 15 percent, and this helped to push up the marginal rate of interest in the economy.

6. These figures relate to the rates of interest on ordinary credit. Where relations between the bank and its clientele are more complex, it is difficult to properly isolate the price of the credit from the total payment for the various services rendered.

7. The implementation of numerous devaluations within a comparatively short period also drove up the cost of foreign currency credit; its effect was analagous to that of a rise in the cost of nondirected IL credit.

8. There was also a heightened probability of a real devaluation of the IL (i.e. by more than the rise in prices), and this of course triggered a heavy demand for foreign currency.

Table XVII-1
CHANGES IN MAJOR MONETARY AGGREGATES, 1973-75
(IL million)

| Period | Balance at end of period | Change in balance | | Average balance | Change in average balance | |
|---|--------------------------|-------------------|------|-----------------|---------------------------|-------------------|
| | | IL m. | % | | IL m. | % |
| Money supply | | | | | | |
| 1973 | 7,392 | 1,805 | 32.3 | 6,315 | 1,274 | 25.3 |
| Jan.-Oct. | 7,133 | 1,546 | 27.7 | 6,118 | | |
| Nov.-Dec. | 7,392 | 259 | 3.6 | 7,298 | | |
| 1974 | 8,722 | 1,330 | 18.0 | 7,566 | 1,251 | 19.8 |
| Jan.-Oct. | 7,970 | 578 | 7.8 | 7,377 | 1,259 ^a | 20.6 ^a |
| Nov.-Dec. | 8,722 | 752 | 9.4 | 8,514 | 1,216 ^b | 16.7 ^b |
| 1975 | 10,614 | 1,892 | 21.6 | 9,913 | 2,347 | 31.0 |
| Unlinked liquid assets of the public^c | | | | | | |
| 1973 | 11,594 | 1,428 | 14.0 | 10,754 | 1,681 | 18.5 |
| Jan.-Oct. | 11,521 | 1,355 | 13.3 | 10,595 | | |
| Nov.-Dec. | 11,594 | 73 | 0.6 | 11,545 | | |
| 1974 | 12,485 | 891 | 7.7 | 11,196 | 442 | 4.1 |
| Jan.-Oct. | 11,504 | -90 | -0.8 | 11,000 | 405 ^a | 3.8 ^a |
| Nov.-Dec. | 12,485 | 981 | 8.5 | 12,177 | 632 ^b | 5.5 ^b |
| 1975 | 14,258 | 1,773 | 14.2 | 13,675 | 2,479 | 22.1 |
| Money base (broadly defined)^d | | | | | | |
| 1973 | 6,942 | 1,460 | 26.6 | 6,071 | 1,099 | 22.1 |
| Jan.-Oct. | 6,918 | 1,436 | 26.2 | 5,885 | | |
| Nov.-Dec. | 6,942 | 24 | 0.3 | 7,004 | | |
| 1974 | 8,064 | 1,122 | 16.2 | 6,713 | 642 | 10.5 |
| Jan.-Oct. | 7,378 | 436 | 6.3 | 6,465 | 580 ^a | 9.8 ^a |
| Nov.-Dec. | 8,064 | 686 | 9.3 | 7,958 | 954 ^b | 13.6 ^b |
| 1975 | 8,569 | 505 | 6.2 | 8,579 | 1,866 | 27.8 |

^a January-October 1974 compared with January-October 1973.

^b November-December 1974 compared with November-December 1973.

^c Money supply, time deposits, and Short-Term Loan.

^d Currency in circulation and the banking institutions' liquid assets (including exemptions from the liquidity requirements).
SOURCE: Money supply — Table XVII-12; unlinked liquid assets — Tables XVII-12 and XVII-13; money base — Table XVII-6.

The crucial question that faced those formulating or assessing monetary policy was whether a smaller injection would have averted some of the demand for foreign currency, or whether it would have primarily affected real activity. It seems that the magnitude of such demand points to a functional relation between the volume of money put into the economy and the volume of foreign currency purchased. In 1975 the external drain amounted to close on 80 percent of the total money base at the beginning of the year, and there is no disputing that it would not have reached such proportions had it not been for the massive infusions. If the reduction of the liquidity inflow had affected real activity, presumably its impact would have been confined to domestic demands, for export activity is assured preferred sources of finance, and therefore this would have accorded with the

Table XVII-2
INDICATORS OF THE TURNOVER VELOCITY OF LIQUID ASSETS
HELD BY THE PUBLIC, 1972-75

| | Average velocity of demand deposits ^a | Annual average velocity relative to GNP ^b | |
|-------------------------|--|--|--|
| | | Money supply | Money supply and unlinked assets |
| 1972 | 24.5 | 5.91 | 3.28 |
| 1973 | | | |
| Jan.-Sept. ^c | 26.1 | | |
| Entire year | 24.2 | 5.99 | 3.52 |
| 1974 | | | |
| April-Dec. ^c | 30.1 | | |
| Entire year | 28.7 | 6.96 | 4.71 |
| 1975 | 31.9 | 7.32 | 5.31 |
| | | Annual average velocity relative to the economy's resource uses ^d | |
| 1972 | | 8.68 | 4.82 |
| 1973 | | 9.07 | 5.33 |
| 1974 | | 11.05 | 7.47 |
| 1975 | | 11.66 | 8.45 |
| | | Annual average velocity relative to the economy's domestic resource uses ^e | |
| 1972 | | 6.60 | 3.67 |
| 1973 | | 7.04 | 4.14 |
| 1974 | | 8.62 | 5.83 |
| 1975 | | 8.95 | 6.49 |

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

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

^c A period of normal economic activity (i.e. excluding the war and national emergency).

^d 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.

^e As defined in note ^d, excluding exports.

SOURCE: Velocity of demand deposits — Department of the Examiner of Banks, Bank of Israel; money supply — Table XVII-12; unlinked assets — Table XVII-13; GNP and total and domestic resource uses — Table II-1.

economic policy targets. The monetary injection this year can be regarded as excessive; it was this that largely fueled demand for foreign currency and prevented a further shrinkage of domestic demands and the shifting of factors of production from nonexport to export branches.

The adjustment of asset portfolios following a structural change in the public's expectations (an increase in the foreign currency component) is most likely to take place among those engaging in current real activity, both domestic and export, and to a much smaller degree among households. This greatly hampers the conduct of an absorptive monetary policy designed to check speculative transactions, if the authorities want to

avoid inhibiting real activity. Since economic policy this year aimed at dampening domestic demand, this constraint proved less severe, and a smaller liquidity injection would have been preferable for attaining both these targets.

It is fallacious to think that real domestic activity can be sustained at the present level side by side with a large-scale acquisition of foreign exchange; the latter factor has a harmful effect on the balance of payments, and is therefore bound to seriously affect real activity in the future.

Table XVII-3

INFLUENCE OF THE PUBLIC AND PRIVATE SECTORS ON THE MONEY BASE,^a 1974-75

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

| | 1975 | | | | | | | | | | | | | |
|--|--------------|------------|------------|-------------|------------|------------|-------------|-------------|------------|-------------|------------|-------------|-------------|------------|
| | 1974 | Jan. | Feb. | March | April | May | June | July | Aug. | Sept. | Oct. | Nov. | Dec. | Total |
| Public sector operations ^b | 3,502 | 156 | 125 | -145 | 496 | 334 | 548 | 270 | 974 | 464 | 1,437 | 570 | 267 | 5,496 |
| Thereof: Government | 2,891 | 67 | 114 | -265 | 410 | 265 | 386 | 185 | 870 | 323 | 1,359 | 445 | 132 | 4,291 |
| Import deposits | -157 | -31 | -20 | -30 | -23 | -19 | 30 | 16 | -3 | -6 | -7 | 29 | 28 | -36 |
| Foreign currency sales by the private sector | -5,169 | 5 | 342 | 392 | 19 | -59 | -825 | -1,103 | -630 | -983 | -713 | -587 | -941 | -5,083 |
| Foreign currency credit to the private sector | 334 | -154 | -242 | -286 | 89 | 38 | 77 | 236 | 174 | 81 | 75 | 15 | -65 | 38 |
| Change in foreign currency deposits of the public | -286 | 108 | -97 | -152 | -86 | -112 | -181 | -96 | -130 | -144 | -220 | -176 | -145 | -1,431 |
| Private sector conversions | -5,121 | -41 | 3 | -46 | 22 | -133 | -929 | -963 | -586 | -1,046 | -858 | -748 | -1,151 | -6,476 |
| Israeli currency credit to the private sector | 1,413 | 146 | -23 | -84 | 56 | 98 | 90 | 129 | 86 | -22 | 117 | 62 | 132 | 757 |
| Open-market operations | 385 | -36 | -63 | 95 | -108 | 0 | 6 | 63 | 66 | 13 | -3 | -25 | 132 | 140 |
| Other factors ^c | 564 | -66 | -35 | 175 | -55 | 53 | 95 | 46 | 40 | 125 | -104 | -34 | 214 | 454 |
| Total increase in money base narrowly defined | 586 | 128 | -13 | -35 | 388 | 303 | -160 | -439 | 577 | -472 | 582 | -146 | 378 | 335 |
| Liquidity exemptions | 454 | 39 | -27 | -57 | 52 | 120 | -71 | 38 | 6 | 49 | 45 | 9 | 40 | 243 |
| Recognized liquidity deficiencies | 82 | -27 | -44 | -13 | 0 | 8 | -1 | -1 | 162 | 35 | -8 | -130 | -53 | -72 |
| Total increase in money base narrowly defined | 1,122 | 140 | -84 | -105 | 440 | 431 | -232 | -402 | 745 | -388 | 619 | -267 | -391 | 506 |

^a Excludes changes in balances due to changes in the IL exchange rate.

^b Changes in net Bank of Israel credit to the government, less purchases of foreign currency (adjusted for food imports) and interest paid to the Bank of Israel.

^c Excludes Bank of Israel profits in foreign currency.

In the first months of the year, when the impact of the November 1974 devaluation was still working its way through the economy and the expectations of another imminent devaluation had vanished, the monetary scene was dominated by the comparatively rapid expansion of the money stock. In May and early June there was a turn of trend, and it grew more pronounced after mid-June with the introduction of a system of creeping devaluation. In the first half of the year, when demand for foreign currency was fairly weak, the money

stock expanded at a 33 percent annual rate, compared with only 10 percent in the second half. Most of the growth of the money base also took place in the first six months, as did all the increase in foreign currency credit; Israeli currency credit, on the other hand, moved up at about the same pace in both subperiods. This pattern is explained by the fact that in the first part of the year the public did not anticipate a devaluation in the near future, as attested by the absence of an agio (premium) on the Natad dollar,⁹ which was going at the official rate of exchange. In the second half of the year the public's expectations and behavior underwent a drastic change, which put a damper on monetary growth; because foreign currency credit had become more expensive, there was a heavier demand for nondirected IL credit. The interest on the latter represented a positive real cost in terms of the local price level, but in foreign currency terms (i.e. relative to credit denominated in foreign currency, whose cost included both interest payable in foreign currency and the rate of the mini-devaluations), it was still comparatively low.

Table XVII-4.
INDICATORS OF THE LIQUIDITY POSITION OF BANKING INSTITUTIONS,^a 1973-75
(percentages)

| End of period | Required liquidity ratio on ordinary deposits | Liquidity exemptions ^b | Actual liquidity ratio on ordinary deposits | Formal liquidity ratio on ordinary deposits (2 + 3) | Gap between actual and required ratio (4 - 1) | Free reserves (IL million; surplus +, deficit -) | | Free reserves as a percent of required liquid asset cover (daily average) | |
|---------------|---|-----------------------------------|---|---|---|--|-------------------------|---|------------------|
| | | | | | | End of month | Daily average for month | Gross | Net ^c |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| 1973 | 72.0 | 13.4 | 52.7 | 66.1 | -5.9 | -283 | -66 | -1.5 | -1.8 |
| 1974 | 72.0 | 20.8 | 50.0 | 70.8 | -1.2 | -67 | 122 | 2.5 | 3.3 |
| 1975 | | | | | | | | | |
| January | 72.0 | 20.8 | 51.5 | 72.3 | 0.3 | 21 | 173 | 3.5 | 4.6 |
| February | 72.0 | 18.6 | 46.3 | 64.9 | -7.1 | -429 | -84 | -1.7 | -2.1 |
| March | 72.0 | 17.3 | 40.0 | 57.3 | -14.7 | -889 | -380 | -7.2 | -9.0 |
| April | 72.0 | 18.0 | 43.1 | 61.1 | -10.9 | -663 | -711 | -13.1 | -16.4 |
| May | 72.0 | 19.5 | 45.2 | 64.7 | -7.3 | -466 | -497 | -8.9 | -11.1 |
| June | 72.0 | 17.6 | 40.0 | 57.6 | -14.4 | -938 | -592 | -10.4 | -13.0 |
| July | 72.0 | 19.1 | 34.6 | 53.7 | -18.3 | -1,141 | -1,018 | -18.1 | -22.9 |
| August | 72.0 | 21.0 | 38.8 | 59.8 | -12.2 | -773 | -1,008 | -17.3 | -22.4 |
| September | 72.0 | 22.2 | 31.7 | 53.9 | -18.1 | -1,243 | -715 | -13.1 | -17.1 |
| October | 70.0 | 22.3 | 38.9 | 61.2 | -10.8 | -713 | -659 | -11.2 | -14.9 |
| November | 72.0 | 20.2 | 36.9 | 57.1 | -14.9 | -968 | -725 | -12.2 | -15.9 |
| December | 72.0 | 19.7 | 29.9 | 49.6 | -22.4 | -1,519 | -1,052 | -18.8 | -24.3 |

^a In this table recognized liquidity deficiencies are included with liquidity exemptions.

^b Includes recognized liquidity deficiencies.

^c The gross required liquidity less liquidity exemptions and recognized deficiencies.

9. For a discussion of the Natad dollar see Chapter XIX.

The sinking of the banks into large liquidity deficiencies (due mainly to the expansion of credit and not to deposit withdrawals) during a period of sizable liquidity injections aggravated the effects of the monetary expansion, a development which the economy could ill afford. Admittedly it is not always possible to offset a public sector liquidity injection by absorbing money from the banking sector, but the magnitude of the incremental injection generated by the liquidity deficiencies was greater than what the economic policy objectives dictated.

The principal monetary policy measure adopted this year was the slapping of a 5 percent liquidity ratio on nondirected bank credit. This was intended to raise the bank interest rate and to influence the composition of the banks' freely loanable funds, and not only their volume. This innovation reflected the shifting of the accent from an attempt to influence the quantity of money to influencing the price of credit. In addition, during the year the yield on the government Short-Term Loan was upped by one point, temporarily stimulating sales of this paper. No further action was taken in the face of the banks' bulging liquid asset deficits. The authorities mainly contented themselves with urging those whose activities have monetary implications, notably the public sector, to reduce the magnitude of the liquidity injection. But when the public sector pumps in huge sums which are used by the private sector to buy foreign currency instead of building up its bank deposits, there is very little the Bank of Israel can do to directly head off the monetary repercussions of the injection.

2. MONETARY DEVELOPMENTS DURING THE YEAR

Because of the weighty monetary consequences which the activities of the government, National Institutions, and private sector had on the economy in 1975, the instruments available to the monetary authorities were inadequate to effectively counteract them. The authorities' ability to neutralize the impact of external infusions is fairly great when they are diverted to bank deposits, but when deposits fail to expand, it is much harder for the authorities to act. As a result, they were reduced this year to relying chiefly on suasion. The two principal policy tools employed in the past--operations in the open market and the Short-Term Loan on the one hand and an attempt to influence the liquidity position of the banks on the other--worked very lamely this year.

As regards the first, the rather inflexible adjustment of interest rates to the policy requirements proved a big handicap; as to the second, while nondirected credit was subjected to the liquidity requirements, the banks' failure to adhere to them and their plunging into persistent, sizable deficiencies largely limited the effectiveness of this

Table XVII-5
CHANGES IN THE BANKING INSTITUTIONS' FREELY LOANABLE RESOURCES, 1975
(IL million)

| | Jan. | Feb. | March | April | May | June | July | Aug. | Sept. | Oct. | Nov. | Dec. | Jan.- Dec. |
|--|------|------|-------|-------|------|------|------|------|-------|------|------|-------|---------------|
| Uses | | | | | | | | | | | | | |
| 1. Credit from banks' own resources ^a | -135 | 177 | 825 | -345 | -284 | 805 | 229 | 246 | 295 | -251 | 32 | 772 | 2,366 |
| 2. Credit to the govt., net ^b | -53 | 46 | 60 | 79 | -3 | -95 | -187 | 7 | 70 | -70 | 39 | 242 | 135 |
| 3. Bond and share purchases in excess of required investments (incl. linkage increments) | -28 | 146 | 31 | 10 | -71 | -22 | 277 | -26 | 285 | -157 | 62 | 133 | 640 |
| 4. Surplus of foreign currency assets | -15 | 0 | -30 | 1 | -8 | 10 | 6 | 17 | 7 | 0 | 1 | 233 | 222 |
| 5. Premises and equipment | 20 | 17 | 13 | 20 | 16 | 18 | 19 | 19 | 11 | 21 | 28 | 26 | 228 |
| 6. Interbank deposits and cash items in process of collection | 104 | 128 | -282 | 37 | 82 | -76 | 17 | 44 | 116 | -108 | -65 | -109 | -112 |
| 7. Total uses | -107 | 514 | 617 | -198 | -268 | 640 | 361 | 307 | 784 | -565 | 97 | 1,297 | 3,479 |
| Sources | | | | | | | | | | | | | |
| 8. Demand deposits and other deposits and creditors | 7 | 87 | 16 | 9 | 58 | 61 | -77 | 70 | 2 | 24 | -21 | 75 | 311 |
| 9. Time deposits ^c | 9 | 37 | -80 | 55 | -11 | -55 | 5 | 64 | 29 | -25 | -15 | 1 | 14 |
| 10. Required liquid cover on credit | 0 | -54 | -8 | -110 | -106 | -27 | -13 | -12 | 1 | 2 | -3 | -11 | -341 |
| 11. Approved savings schemes | 64 | 88 | 114 | 74 | 89 | 125 | 68 | 23 | 76 | 73 | 28 | 91 | 913 |
| 12. Equity capital and capital notes | 18 | 4 | 5 | 2 | 1 | 91 | 160 | 311 | 74 | 55 | 4 | 154 | 879 |
| 13. Rediscounts and recognized liquidity deficiencies | -21 | -28 | -8 | -12 | 10 | 10 | -3 | 165 | 7 | 31 | -122 | -62 | -33 |
| 14. Other accounts, net (incl. net linkage increments other than on securities) | -96 | -70 | 118 | 10 | -112 | -37 | 18 | 54 | 125 | -195 | -30 | 499 | 284 |
| 15. Total uses | -19 | 64 | 157 | 28 | -71 | 168 | 158 | 675 | 314 | -35 | -159 | 747 | 2,027 |
| 16. Change in liquidity deficiencies (7-15) | -88 | 450 | 460 | -226 | -197 | 472 | 203 | -368 | 470 | -530 | 256 | 550 | 1,452 |

^a Includes the banks' participation in directed credit funds and in credit from earmarked deposits (net of approved loans).

^b Excludes government bonds and deposits with the Treasury against housing savings scheme funds.

^c The liquidity requirement on account of deposits withdrawn prematurely has been taken into account.

step. To some extent the reason lay in the unsymmetrical efficacy of the policy instruments; when there is need for reflationary action the instruments prove to be fairly potent for expanding the banks' freely loanable resources (through rediscounts, lowering of liquidity ratios, and so forth), but when a contractionary policy is in force their efficacy is diminished. The crucial problem confronting monetary policy in 1975 arose from the fact that there was not only too large a public sector injection, but that the banking institutions joined the other stimulative factors, by running huge liquidity deficiencies whose expansionary effect eclipsed that of the ordinary bank multipliers.

In the year reviewed the relative importance of the short-term monetary policy objectives apparently underwent a change. The long-run goal of macroeconomic policy is to achieve a balanced growth of the economy, with a minimum of unemployment and inflation and a manageable balance of payments deficit. For operative purposes policymakers must determine which of the principal monetary aggregates constitute short-term objectives capable of contributing to the attainment of the long-range goals.

Three variables fall into this category: the money supply, volume of credit, and interest rate structure. The relative importance of each is likely to vary with circumstances; in general, the more open the economy, the smaller the importance attaching to the money supply and the greater the importance of the other two variables. This is because in an open economy, where local currency can be converted into foreign currency, there may arise a situation in which a sizable monetary injection will lead to the creation of new money; this will be converted in the process of purchasing foreign currency, with the result that the observer will be led to believe that the money supply is holding steady or even contracting. He may conclude that monetary developments are having too restrictive an effect and are not contributing to the growth of demand and imports, and that stimulative action may be called for.¹⁰ On the other hand, the amount of credit granted and its price do not change according to the use to which it is put (i.e. whether for meeting domestic or foreign demand), and therefore it should be accorded priority. The monetary assessments and policy decisions were made in 1975 on the strength of an analysis of these three financial variables, with less weight than usual placed on the movement of the money supply.

The main monetary policy measure this year was, as mentioned, the subjecting of nondirected bank credit to the liquidity requirements in an effort to retard monetary

10. What is more, the importance of the money supply as an indicator for guiding policymakers diminishes the greater the array of the economy's financial assets and its weight in the liquid financial assets portfolio declines.

expansion. This was intended to raise the interest rate and reduce the banks' freely loanable liquid assets, thereby cutting down their credit business and the quantity of money in the economy.¹¹ The Bank of Israel was bent on influencing not only the total amount of the commercial banks' freely loanable funds, but also the uses to which they could be put: it penalized the channeling of such money for expanding credit at the expense of investment in securities, fixed assets, etc. As already explained, the employment of this instrument by the central bank reflected the shift in emphasis from an attempt to influence the money supply to influencing the quantity and price of credit. The liquidity requirement on credit went into force in February, with the rate being initially set at 1 percent and scaled up gradually to 5 percent by the middle of May. This added some IL300 million to the banks' required liquid asset cover and 2.5 percentage points to the cost of nondirected credit; it is therefore a reasonable inference that this was one of the factors pushing up the interest on such financing.

In addition, in the course of the year the interest on directed IL credit granted through the working capital funds was jacked up by two points and that on the Short-Term Loan by one point, but this had only a marginal impact on monetary developments. At the end of the year the liquidity requirements were extended to cover new buy-back agreements, but this began to leave its impress only in the early part of 1976 (see section 4b).

The monetary authorities should have attempted to restrict the liquidity injection to an amount sufficient to finance the structural balance of payments deficit and the anticipated price increases arising from the government's policy and the modification of the exchange rate and wage agreements. But the amount of money actually put into the economy far exceeded this, thereby permitting the purchase of foreign currency over and above what was required for financing the structural balance of payments deficit.

Although the Bank of Israel did not succeed in making the banks wipe out their liquidity deficiencies, its refusal to approve retroactively the injection generated by their deficiencies served the monetary policy objectives in that it made nondirected bank credit costlier. At the beginning of 1976 the liquidity ratios on demand and time deposits were reduced by two and three percentage points respectively, and this led to the erasing of some IL250 million from the deficiencies. In addition, the Bank of Israel gave the commercial banks IL400 million in short-term credit with the proviso that they do not

11. Unlike several other central banks, the Bank of Israel is unable to directly influence the interest rate through discount-window operations. Accordingly it tries to influence the cost of credit in a roundabout manner, such as revising the penalty rates for liquidity shortfalls and the liquidity ratios on various assets and liabilities, etc.

expand their nondirected credit; it also purchased from them some IL270 million of nontradable bonds, and injected approximately IL300 million through its open-market operations in the first four months of 1976.

Table XVII-6
THE MONEY BASE, BY COMPONENT, 1973-75
(IL million)

| End of period | Currency in circulation | Liquid assets of banking institutions | Money base narrowly defined (1 + 2) | Liquidity exemptions | Recognized liquidity deficiencies | Money base broadly defined (3+4+5) | |
|---------------|-------------------------|---------------------------------------|-------------------------------------|----------------------|-----------------------------------|------------------------------------|------------------|
| | | | | | | IL m. | Percent increase |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
| 1973 | 2,715 | 3,588 | 6,303 | 614 | 25 | 6,942 | 25.6 |
| 1974 | 3,173 | 3,716 | 6,889 | 1,068 | 107 | 8,064 | 16.1 |
| 1975 | | | | | | | |
| January | 3,242 | 3,775 | 7,017 | 1,107 | 80 | 8,204 | 1.7 |
| February | 3,467 | 3,537 | 7,004 | 1,080 | 36 | 8,120 | -1.0 |
| March | 3,661 | 3,308 | 6,969 | 1,023 | 23 | 8,015 | -1.3 |
| April | 3,687 | 3,670 | 7,357 | 1,075 | 23 | 8,455 | 5.5 |
| May | 3,672 | 3,988 | 7,660 | 1,194 | 31 | 8,885 | 5.1 |
| June | 3,692 | 3,809 | 7,501 | 1,123 | 30 | 8,654 | -2.6 |
| July | 3,726 | 3,334 | 7,060 | 1,161 | 29 | 8,250 | -4.7 |
| August | 3,931 | 3,708 | 7,639 | 1,167 | 191 | 8,997 | 9.1 |
| September | 3,930 | 3,237 | 7,167 | 1,217 | 226 | 8,610 | -4.3 |
| October | 3,960 | 3,789 | 7,749 | 1,261 | 218 | 9,228 | 7.2 |
| November | 3,876 | 3,727 | 7,603 | 1,270 | 88 | 8,961 | -2.9 |
| December | 3,970 | 3,254 | 7,224 | 1,310 | 35 | 8,569 | -4.4 |

Unlike other components of a liquidity injection, which may be essentially regarded as an "implication" of nonmonetary activity, the behavioral pattern of the banking institutions is a direct outcome of monetary policy, although the policymakers cannot always sway developments in this area. The incurring of a liquidity deficiency is actually a substitute for an external drain. It is subject to the bank's own decision and involves the payment of a fine;¹² hence, from the standpoint of the bank, the deficiency represents a financial transaction whose worthwhileness is judged by ordinary commercial considerations.¹³ At the same time, however, a liquidity deficiency has general monetary

12. The schedule of fines for exceeding the liquidity directives is fairly complex and is dependent upon administrative procedures and various economic developments. In 1975 the penalty reached an effective level of nearly 50 percent (considering that it is not recognized as a deductible expense by the tax authorities). Introduction of the income tax reform brought up the effective rate, as it raised taxes and interest and linked back taxes to the cost-of-living index.

13. These considerations include *inter alia* an assessment of the prospects of the

implications, since it impairs the effectiveness of the principal monetary instrument of the Bank of Israel, namely liquidity ratio policy. It would therefore be pertinent to examine the development of the banks' liquid asset shortfalls in the course of the year and their monetary repercussions.

In the final months of 1974 the banks extricated themselves from the liquidity deficit position in which they found themselves before the November devaluation, while in the course of the present year they again incurred deficiencies which, after sharp swings in both directions, reached some IL1.5 billion (IL500 million in December alone), with the average for the year being IL700 million.

Analysis of the changes in the size and composition of the banks' shortfalls during the year reveals that in February they began to display a rising trend, with the fluctuations sometimes reaching as much as IL500 million; in April, May, August, and October the level turned downward, but in the other months it rose precipitately (see Tables XVII-4 and XVII-5). Examination of the sources and uses of the banks' freely loanable funds¹⁴ shows that the widening of the deficit did not stem from the withdrawal of deposits by the public, but originated in the uses to which the banks put the money. Whereas the growth of demand and time deposits and equity capital added some IL2 billion to the banks' resources, the uses expanded far more, with the most striking item being the IL2.4 billion credit outflow. Obviously there is a connection between total uses and total sources of funds, but the relatively small dimensions of the liquidity deficiencies compared with the other sources of the infusion (IL1.5 billion as opposed to IL6.9 billion) must be kept in mind; the IL1.5 billion growth of the deficiencies was therefore due mostly to uses expanding more than sources.¹⁵

A glance at Figure XVII-1 shows that in every month of the year the liquidity deficiency moved in a direction directly opposite to that of the money base broadly

clients' becoming financially entangled or going bankrupt if sufficient credit is not made available to him--a factor that assumes increasing importance with a slowdown in economic activity. In general the banks, like all other large firms, are guided not by the profitability considerations of marginal transactions but by the whole complex of its relations with the client in the long run.

14. The reference is to that part of the funds raised by banking institutions which may be used for purchasing assets at their own discretion. The sources of such funds are deposits in excess of the required liquid asset cover, security issue proceeds, and accumulated undistributed profits. The money is used for granting nondirected credit, participating in directed credit funds and in credit supplied from earmarked deposits, purchasing noncompulsory securities, and investing in premises and equipment for the banks' own use.

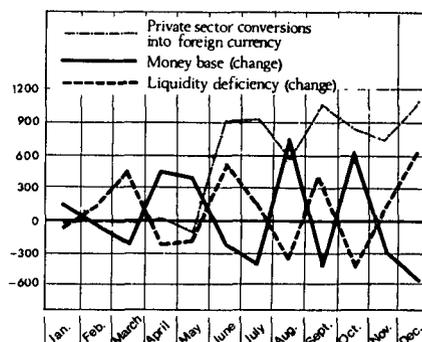
15. The IL640 million increase (after revaluation) in obligatory investment in securities should be compared with the IL913 million growth of the freely loanable portion of the banks' approved savings scheme funds. This indicates that the banks preferred to keep a rough balance between their value-linked assets and liabilities rather than finance unlinked uses with linked liabilities.

defined; that is to say, in those months when the money base shrank the deficiency widened, and vice versa. This phenomenon can be interpreted in two different ways. On the one hand, it can be said that the banking institutions deliberately attempted to create countercyclical external infusions, thereby helping to stabilize the monetary aggregates--which, of course, was desirable and positive. On the other hand, this correlation may be taken as signifying an inverse causal relation: in those months when the banks stepped up their credit operations and incurred deficiencies, the private sector increased its foreign currency purchases and the money base contracted, whereas when the banks curbed their lending business, demand for foreign currency eased and the money base expanded. To determine the correct interpretation requires an analysis of all the foreign currency demand components, but a cursory examination shows that from June, when the pattern of demand for foreign currency began to change, until the end of the year there was a correlation between the direction of the change in the deficiency and the change in conversions in six of the seven months.¹⁶ It is therefore plausible to assume a causal relationship between the size of the deficiency and the volume of conversions. Table XVII-5 reveals that it was the growth of credit and not a shrinkage of deposits that pushed the banks into a deficit position (it may nevertheless be that in the very short run the banks' policy also had a countercyclical effect).

The liquidity shortfalls and the fines are defined and calculated in a progressive manner so as to enable the banks to respond to short-run changes in demand for credit and deposits. Thus they are not penalized for brief shortfalls which are offset by subsequent surpluses. On the other hand, when there is a protracted deficiency the penalty rate is gradually scaled up; this is designed to discourage the incurring of persistent deficits, which clashes with monetary policy. Despite the progressiveness of the fines, this instrument has apparently proved to be an insufficient deterrent, for the banks have been in a deficiency position for a long time.

16. The only exception was November, when the deficiency grew by IL260 million and foreign currency purchases declined, but still amounted to IL750 million.

Figure XVII-1
CHANGES IN MONEY BASE AND
BANKS' LIQUIDITY DEFICIENCIES
IN 1975, MONTHLY
(IL million)



3. SOURCES OF MONETARY EXPANSION

(a) *The Money Base*

The money base broadly defined expanded more slowly in the year reviewed--by IL500 million, or 6.2 percent, as against IL1,120 million, or 16.1 percent, in 1974. The smaller increase this year reflected contrasting developments. On the one hand, there was a huge liquidity injection: the government's operations (i.e. the surplus of its expenditure over revenue in Israeli currency) put IL4.3 billion into the economy, with the other public sector authorities (chiefly the National Institutions) accounting for IL1.2 billion, and the Bank of Israel for IL1.3 billion, mainly through the provision of directed credit; the total amount pumped in from these sources was IL6.8 billion. On the other hand, the private sector was responsible for a IL6.5 billion absorption via its balance of payments (on both current and capital account). The net effect on the narrow money base thus totaled IL300 million; if we add credit granted within the framework of liquidity exemptions and recognized shortfalls from the liquidity requirements, we find that the broad money base expanded by IL500 million, with the trend displaying fairly sharp month-to-month fluctuations.

The seasonal pattern of the government's injection was fairly similar to that the year before: in the first three months of 1975 (the final quarter of the fiscal year, when the government has to repay its short-term advances from the Bank of Israel) its influence was neutral, whereas during the rest of the year it pumped in sums ranging from IL100 million to IL1.3 billion a month.

The variations in the government's injection are partly due to the size and timing of the various revenue and expenditure items, but the influence of government bond sales must be stressed. The data cited above are after netting out both bond sales and redemptions; in this sense there is a feedback of the movement of the broad money base on the government's primary injection.¹⁷

In July the income tax reform went into force, and this deprived the Treasury's coffers of an estimated IL1.5 billion of direct revenue for the year, since the value added tax, which was supposed to compensate the Treasury for the loss of direct tax revenue, was not yet implemented.

The private sector, as stated, caused the drawing out of IL6.5 billion through its

17. In a month when an exceptionally large amount is pumped into the economy by the government or some other source, part of the money is likely to be used for buying newly issued bonds and hence will flow back to the Treasury; in this case the monthly calculations will show a more modest injection.

balance of payments. It purchased foreign currency from the Bank of Israel in this amount to finance that part of its current deficit not covered by capital imports. This sum was equal to 80 percent of the broad money base at the beginning of the year, and it is obvious that had it not been for the large liquidity injection the sector would not have been able to acquire foreign currency on such a large scale without sharply depressing the money stock. The foreign currency purchases did not proceed at an even pace over the year, and two distinct subperiods can be distinguished. In the first four months the private sector sold some \$30 million a month net to the Bank of Israel, while in the last eight months it purchased from the Bank an average of \$110 million a month. The trend in the first period is partly explained by the fact that it was still influenced by the November 1974 devaluation (which of course led to the virtual disappearance of expectations of another devaluation in the near future, dampened speculative demand for foreign currency, and even led to a return flow of money from abroad); the increased sale of foreign currency to the central bank was partly due to a seasonal upsurge in export proceeds, and in part it was connected with the larger volume of foreign currency credit supplied to the private sector by the commercial banks in place of foreign currency purchases from the Bank of Israel (see section 4d). In May, and especially after the introduction of the creeping devaluation in June, the picture changed: the private sector began to buy foreign currency on an appreciable scale, a trend that continued to the end of the year. To some extent this reflected the reshuffling of the public's assets portfolio in line with its changing expectations (a one-shot adjustment, which is perforce greater than the impact of a change in the current allocation of financial assets). It was also due to the shrinkage of the other sources of foreign currency, which forced the public to turn to the Bank of Israel. As already indicated, the heavier purchase of foreign currency greatly retarded the expansion of the money base.

The fluctuations in foreign currency credit granted by the Bank of Israel stemmed primarily from a change in the sources of financing the Diamond Fund, and only to a minor extent from changes in the amount of financing supplied to customers. The Bank's participation in directed IL credit injected IL930 million this year, in the form of rediscounts, liquidity exemptions, and recognized liquidity deficiencies (the development of the various types of credit is described in section 4d).

Foreign currency deposits of restitution recipients and others were, as in 1974, a moderating factor, preventing the expansion of the money base by an additional IL1.4 billion. This item was fairly stable in the year reviewed, the slight monthly variations being due to the fluctuating pace at which restitutions flowed into the economy and to

changes in the external value of the principal world currencies. In the second half of 1975 such deposits increased fractionally, as the public adjusted its assets portfolio in favor of foreign currency items.

The Bank of Israel's open-market operations put IL140 million into the economy this year. But IL132 million of this sum was pumped in during the second half of December alone, following the Bank's decision to firm government bond prices after a rush of sales in the wake of the security market reform (see Chapter XIX). Apart from this action, the Bank's operations in the open market did not affect the size of the injection, although during the year they described a fairly erratic path, due partly to fluctuations in Stock Exchange trading and partly to the buy-back arrangement between the commercial banks and the Bank of Israel.

(b) *Bank Credit to the Public*

The total amount of Israeli currency credit (directed and nondirected alike) was, at IL11.4 billion, up 32 percent in 1975, after soaring 48 percent the year before. On an annual average, the increases in the last two years were similar (about 35 percent), which is explained by the upsurge in directed credit in the second half of 1974. The growth of foreign currency credit to local borrowers slowed conspicuously, from 41 percent last year to 23 percent (in dollar terms), and totaled IL7.3 billion; the annual average rise was 39 percent this year, as contrasted with 63 percent in 1974. Directed IL credit linked to the exchange rate increased faster (in dollar terms) than in 1974--34 vs. 24 percent--and came to IL1.3 billion. Total bank credit to the public thus hit IL20 billion by the end of the year reviewed, compared with IL14.4 billion last year--up 38.2 percent. There was also an increase in credit from earmarked deposits of the government and financial institutions: the amount granted by the banks from financial institution funds rose 47 percent to IL8 billion, while that from government deposits for the payment of tax debts and other purposes went up by a resounding 56 percent to IL4.3 billion. (It should be pointed out that the growth of these two types of credit has different implications from those of the expansion of ordinary bank credit--see Chapter XVIII, "The Institutional Structure of the Capital Market".)

Over the years directed credit, which was introduced in the 1950s to ensure financing for high-priority activities during a period of credit freeze, has come to have (especially in the last two or three years) a large subsidy element, due to the widening differential between the rates of interest charged on such financing and the going free-market interest rates.

Table XVII-7

**OUTSTANDING CREDIT GRANTED TO THE PUBLIC^a BY THE BANKING SYSTEM
(EXCL. LINKAGE DIFFERENTIALS), 1974-75**

(IL million)

| End of period | Nondirected commercial bank credit in IL | Directed credit in IL ^b | | Foreign currency credit through the funds | | Foreign currency credit outside the funds | | Total bank credit to the public | Credit from earmarked nongovt. deposits | Credit from govt. deposits | |
|---------------------------|--|------------------------------------|--------------------------------------|---|--------------------------------------|---|--------------------------------------|---------------------------------|---|----------------------------|-------------------------|
| | | Total | Rediscounts and liquidity exemptions | Total | Rediscounts and liquidity exemptions | Total | Rediscounts and liquidity exemptions | | | To taxpayers etc. | From earmarked deposits |
| 1974 | 5,434 | 3,992 | 3,121 | 1,411 | 1,395 | 3,608 | 243 | 14,445 | 5,431 | 606 | 2,128 |
| 1975 | | | | | | | | | | | |
| January | 5,218 | 4,211 | 3,327 | 1,426 | 1,214 | 3,973 | 252 | 14,828 | 5,516 | 625 | 2,099 |
| February | 5,393 ^c | 4,195 ^c | 3,254 | 1,505 | 972 ^d | 4,801 | 257 | 15,174 | 5,630 | 630 | 2,098 |
| March | 6,075 | 4,104 | 3,101 | 1,450 | 696 ^d | 4,132 | 255 | 15,761 | 5,925 | 784 | 2,152 |
| April | 5,699 | 4,253 | 3,227 | 1,542 | 762 | 4,337 | 260 | 15,831 | 6,031 | 809 | 2,135 |
| May | 5,462 | 4,361 | 3,399 | 1,607 | 819 | 4,549 | 253 | 15,979 | 6,238 | 820 | 2,157 |
| June | 5,983 | 4,551 | 3,442 | 1,677 | 911 | 4,602 | 257 | 16,813 | 6,550 | 835 | 2,175 |
| Devaluation differentials | 0 | 18 | 19 | 34 | 19 | 94 | 5 | 146 | 0 | 0 | 0 |
| July | 6,166 | 4,761 | 3,611 | 1,748 | 1,140 | 4,421 | 263 | 17,096 | 6,743 | 876 | 2,197 |
| August | 6,359 | 4,889 | 3,709 | 1,740 | 1,354 | 4,499 | 263 | 17,487 | 6,942 | 975 | 2,220 |
| Devaluation differentials | 0 | 17 | 17 | 33 | 24 | 87 | 5 | 137 | 0 | 0 | 0 |
| September | 6,660 | 5,027 | 3,752 | 2,032 | 1,712 | 5,043 | 287 | 18,762 | 7,007 | 1,167 | 2,248 |
| Devaluation differentials | 0 | 111 | 111 | 223 | 181 | 548 | 32 | 882 | 0 | 0 | 0 |
| October | 6,446 | 5,248 | 3,994 | 2,126 | 1,700 | 4,979 | 285 | 18,800 | 7,256 | 1,336 | 2,313 |
| November | 6,379 | 5,314 | 4,057 | 2,190 | 1,774 | 5,225 | 276 | 19,108 | 7,591 | 1,250 | 2,421 |
| Devaluation differentials | 0 | 17 | 17 | 31 | 25 | 73 | 4 | 121 | 0 | 0 | 0 |
| December | 7,072 | 5,559 | 4,265 | 2,125 | 1,691 | 5,200 | 267 | 19,956 | 8,006 | 1,489 | 2,761 |

^a Excludes credit to the government and National Institutions.^b Includes directed IL credit linked to the exchange rate.^c The banks' IL 95 million participation in the financing of imported trucks and equipment was transferred in February 1975 from nondirected credit to directed IL credit.^d The decrease was due to changes in the sources of financing the Diamond Fund.*1. Nondirected credit in Israeli currency*

After a 34 percent growth in 1974, nondirected IL credit rose by another 30 percent in the year reviewed to reach IL7.1 million. The balance did not move up until the middle of March, since the credit freeze imposed the previous August remained in force until February 12; in addition, the private sector had plenty of liquidity after the November 1974 devaluation and the subsequent conversion of foreign currency. After the lifting of the credit freeze an obligatory liquidity ratio was slapped on outstanding nondirected credit, which was scaled up progressively until it reached 5 percent by the middle of May.

In the latter part of March there was a brief spurt in such finance in the wake of the Treasury's effort to step up tax collections and postpone payments so as to reduce its advances from the Bank of Israel. From April until the end of May the balance of such

credit fell to its previous level, but June saw a renewed heavy demand following the introduction of the system of creeping devaluation and the mounting expectation of an increase in the cost of foreign currency credit relative to that in Israeli currency.

The formal interest rates on nondirected credit were raised three times during the year (in April, May, and September) for a total of five points, and the fines for drawings in excess of the established overdraft facilities were also hiked steeply.¹⁸ In the course of the year (especially the latter part) the cost of nondirected credit to sound borrowers reached 30 percent or more,¹⁹ whereas the consumer price index went up only 23.5 percent. Thus, for the first time in three years, the real interest rate was positive, and this may lead to a more rational use of such financing from the macroeconomic standpoint. In this connection it is interesting to note that, whereas in previous years complaints had frequently been voiced about a shortage of credit (which of course reflected its rationing in the face of a fairly flexible demand during a period of negative real interest), this year, despite the relatively sluggish growth of such financing, there was less grumbling on this score but more about its dearer cost. The provision of nondirected bank credit on linked terms has given rise to a similar complaint, although its volume is not very large and the recipients are not commercial borrowers but institutions and primarily local authorities.

Bank interest rates were raised partly because of Bank of Israel policy and partly because of market forces. On the one hand, there was a livelier demand for IL credit in place of foreign currency credit (the reference, of course, is to that part which does not carry exchange rate insurance cover) for financing various types of foreign currency transactions as well as the buildup of stocks during a period of sagging demand unaccompanied by a corresponding cutback in production and other economic activity. This year sales of index-linked bonds were not an important factor in credit demand, because of the belief that prices would not spiral upward as fast as in 1974, and especially because of the very hesitant tone of the securities market throughout most of the year. As regards supply, the sources of nondirected bank credit became much more expensive, and this pushed up the interest rate charged borrowers. The principal sources of such credit in 1975 were

18. Since September borrowers exceeding the approved overdraft facilities have been paying a 15 percent fine on top of the regular interest. Current data are not available on the volume of credit granted in the form of such excess drawings, but from end-of-year data it turns out that some 20 percent of total overdraft finance was granted in the form of excess drawings, whose cost was 15 percent higher, approaching the 50 percent mark.

19. The reference is mainly to credit granted in the form of overdraft facilities to nonpreferred sound commercial borrowers. The interest charged other borrowers was slightly lower, but where the client does all or much of his banking with a single concern, it is of course hard to estimate the price of the individual services rendered.

the mobilization of equity capital, the expansion of approved savings scheme funds (the amount over and above what has to be invested in bonds), and the incurring of liquidity deficiencies (which increased partly because of the extension of the liquidity requirements to nondirected credit); these sources are much more expensive than the conventional ones, namely demand and time deposits. Table XVII-5 shows that of the IL3.5 billion of the banks' total freely loanable funds, IL1.5 billion represented the increase

Table XVII-8
BANK CREDIT TO THE PUBLIC, 1974-75

(IL million)

| | Balance Dec. 31, 1975 (IL m.) | Percent increase | | | | | |
|---|-------------------------------------|------------------|-----------|----------------------------|-----------|----------------|------------|
| | | | | End-June-Dec. ^a | | Annual average | |
| | | 1974 | 1975 | 1974 | 1975 | 1974 | 1975 |
| IL credit | 11,351 | 48 | 32 | 17 | 19 | 35 | 34 |
| Nondirected | 7,072 | 34 | 30 | 1 | 18 | 25 | 20 |
| Directed | 4,279 | 86 | 34 | 60 | 20 | 66 | 66 |
| Export production | 1,633 | 49 | 66 | 29 | 19 | 45 | 72 |
| Citrus and cotton | 578 | 67 | 48 | 160 | 182 | 42 | 25 |
| Indirect exports and working capital ^b | 1,428 | 151 | 27 | 135 | 13 | 83 | 93 |
| Other | 640 | 84 | -7 | 15 | -13 | 99 | 42 |
| Directed IL credit linked to the exchange rate^c | | | | | | | |
| Export shipments | 1,280 | 24 | 34 | 3 | 12 | 8 | 24 |
| | | <i>78</i> | <i>59</i> | <i>48</i> | <i>30</i> | <i>16</i> | <i>76</i> |
| Foreign currency credit^c | 7,325 | 41 | 23 | 9 | 1 | 63 | 39 |
| Through the funds | 2,125 | <i>101</i> | <i>46</i> | <i>56</i> | <i>17</i> | <i>76</i> | <i>93</i> |
| Diamonds | 1,802 | 19 | 27 | -1 | 9 | 18 | 34 |
| Imports for export production | 323 | 70 | 51 | 41 | 27 | 27 | 89 |
| Outside the funds | 5,200 | 24 | 26 | -4 | 13 | 22 | 30 |
| From banks' own means | 4,933 | 77 | 49 | 37 | 31 | 32 | 84 |
| General approvals | 3,389 | -3 | 32 | 21 | -8 | -7 | 64 |
| Imports on consignment | 954 | 37 | 58 | 70 | 8 | 1 | 127 |
| Fuel imports | 1,941 | 51 | 22 | 14 | -3 | 95 | 42 |
| Other | 494 | <i>116</i> | <i>44</i> | <i>63</i> | <i>13</i> | <i>111</i> | <i>100</i> |
| Specific approvals | 1,544 | 52 | 24 | 25 | -2 | 98 | 43 |
| Rediscounts | 267 | <i>118</i> | <i>47</i> | <i>62</i> | <i>14</i> | <i>114</i> | <i>102</i> |
| Grand total | 19,956 | — | 42 | — | -8 | — | — |
| | | — | 68 | — | 7 | — | — |
| | | — | 14 | — | -40 | — | — |
| | | — | 35 | — | -30 | — | — |
| | | — | 101 | — | 20 | — | — |
| | | — | 138 | — | 39 | — | — |
| | | — | 15 | — | 1 | — | — |
| | | — | 0 | — | 17 | — | — |
| | | — | -4 | — | 14 | — | — |
| | | — | 14 | — | 33 | — | — |
| | | 46 | -7 | 32 | -10 | 62 | 24 |
| | | <i>94</i> | <i>10</i> | <i>88</i> | <i>4</i> | <i>75</i> | <i>72</i> |
| | | 65 | 38 | 30 | 19 | 43 | 53 |

^a The creeping devaluation was instituted at the end of June 1975.

^b The agricultural and industrial working capital funds, supervised agricultural fund, and the Employers Loan Fund.

^c The figures in regular type are the rates of change in dollar terms; those in italics are the rates of change in IL terms.

in the banks' liquidity shortfall, IL900 million was in the form of equity capital and capital notes, another IL900 million derived from savings scheme deposits, and only IL300 million originated in demand and time deposits.

Whereas in the past the prospective yield on a linked bond investment in effect put a floor on the bank interest rate, today the anticipated yield on a foreign currency investment serves this purpose.²⁰ Since the system of creeping devaluation makes it virtually certain that the IL will be devalued by at least 25 percent during the year (2 percent a month), the cost of foreign currency credit comes to 35 percent or more; hence it is a reasonable inference that some of the economic units having to repay foreign currency credit will prefer to take on nondirected IL loans in its stead. To sum up, it can be said that the present rate of interest is not the product of a combination of temporary demand or supply developments, but is rooted in the structure and reality of the local economic scene.

At the end of 1975 nondirected credit accounted for 56 percent of total IL bank credit to the public (about the same proportion as the year before) and 35 percent of aggregate bank credit to the public in Israeli currency, foreign currency, and that linked to the exchange rate, as compared with 37.5 percent in 1974. The stabilization of the share of such finance checked the general declining trend of previous years, but it is important to note that concurrently the banking institutions sank into unprecedented liquidity deficiencies. In other words, while the tapering off of the proportion of nondirected credit was in itself a positive development, it coincided with a steep jump in the total volume of credit, and the expansion of nondirected credit was connected with the incurring of large liquidity deficiencies. It would have been preferable to achieve this result through a slower growth of directed credit.

2. *Directed Israeli currency credit*²¹

In discussing the development of such credit it would be pertinent to note its determinants. A distinction can be made between credit provided for export and that for working capital. The first is granted mostly according to a predetermined formula; it is therefore a function of the volume of current activity, and the Bank of Israel has only a limited influence over its size. On the other hand, working capital credit is granted in

20. The term "foreign currency investment" is used here in the broad sense, including, in addition to purchases of foreign currency, the repayment of foreign liabilities, an increase in raw material stocks purchased with foreign currency, etc.

21. Excluding credit granted through the Export Shipments Fund, which appears under directed IL credit linked to the exchange rate.

accordance with the branchwide arrangements concluded from time to time, and the decisions taken are likely to influence the volume of these funds; to increase the maximum amount of finance necessitates deliberations and an explicit decision to this effect.

Directed IL credit expanded 34 percent in 1975 (as against 86 percent the year before) to total IL4.3 billion. On an annual average, the growth rates in the last two years were the same (66 percent); this is explained by the fact that in 1974 most of the increase took place in the second half, when the bulk of the reservists called up during the Yom Kippur War were released.

The largest of the directed credit funds is the Export Production Fund (IL1.6 billion at the end of the year), and it also recorded the fastest rate of increase this year--66 percent. As in all the other export funds, growth was sluggish in the first three months of the year, and there was even a downturn after completion of the credit allocations at the end of March and the revision of the export estimates; the amount of finance supplied through this fund in the first quarter of 1975 was down 6 percent.

The seasonal pattern in the use of directed credit shows a rational behavior on the part of exporters, in that they preferred as far as possible the use of cheap credit. In the first four months of the fiscal year (April-June), after approval of the new credit quotas, the outstanding balance soared 63 percent, while during the rest of the year it went up by only another 6 percent. This pattern differs sharply from that of credit linked to or denominated in foreign currency, such as the Export Shipments Fund (see below), since the upscaling of the export estimates is reflected in the Export Production Fund immediately at the beginning of the year, whereas in the Export Shipments Fund the increase is spread over the year accordingly as the sales are actually implemented.

The uptrend in the working capital funds slowed appreciably this year, mainly because of the standstill in the balance of the Employers Loan Fund, which was one of the principal growth factors the year before. Excluding this fund, the increase in the working capital and indirect export funds came to 38 percent.

3. Directed IL credit linked to the exchange rate

At present there is only one fund coming under this category: the Export Shipments Fund, which provides those dispatching their goods abroad with Israeli currency credit linked to the exchange rate and bearing 6 percent interest. At the end of 1975 the balance of this fund stood at IL1.3 billion, after rising 34 percent during the year in dollar terms and 59 percent in IL terms. The demand for such financing is influenced, first and foremost, by devaluation expectations and by the relative size of the export incentives.

The worthwhileness of such credit decreases with the heightening of expectations of a devaluation during the period of the credit; the receipt of such funds also sets back the date of receipt of the export incentives. The terms of the financing supplied by the fund are therefore comparatively stiff and the subsidy element is small; consequently, exporters generally do not utilize the maximum amount of such funds at their disposal.

In the first quarter of 1975 the balance of this fund rose 13 percent, after remaining virtually static during the period preceding the 1974 devaluation. Upon the renewal of devaluation expectations demand for such credit again declined, and between April and July it inched up by a mere 1 percent. In August demand again became brisk, and by the end of the year the balance rose 17 percent (excluding devaluation differentials). This upswing during a period of creeping devaluation is further evidence of the monetary tightness that characterized the last months of the year.

4. Foreign currency credit

Foreign currency credit to local borrowers falls into two categories: directed credit and approved credit, which is granted on nonpreferential terms in accordance with the banking institution's commercial considerations, with the specific or blanket approval of the Treasury. The borrower is sometimes insured against a change in the exchange rate during the period of the loan. At the end of 1975 outstanding foreign currency credit reached IL7.3 billion; of this, IL1.9 billion was for financing fuel imports, which are not closely connected with ordinary economic activity. The balance was intended for ordinary short-term financing, and its impact on economic activity resembled that of IL credit.

Directed credit is supplied mainly for financing imports for export production through the Diamond Fund and the Imports-for-Export Fund; in addition, special rediscount facilities are granted for specific purposes. The balance of these funds went up 27 percent during the year in dollar terms (as against 19 percent last year), and reached IL2.1 billion; of this, IL1.8 billion was in the Diamond Fund and IL300 million in the Imports-for-Export Fund. The slightly faster expansion of these funds this year was apparently associated with the advance in world prices and perhaps also with an increase in the economy's raw material stocks. In this context it should be pointed out that the financing arrangements of the Diamond Fund do not necessarily ensure a close connection between changes in the volume of diamond polishing and the physical stock on the one hand and changes in the volume of financing on the other.

Rediscounts outside the funds were down a notch, but because of their rapid increase in 1974 the annual average level was up 24 percent this year.

As regards credit granted under blanket approvals, that for import consignments, which

is used for financing stocks of imported raw materials, deserves attention. This credit is made available in foreign currency at interest of 10 percent, with no exchange rate insurance coverage. As long as international raw material prices continued to advance and no early devaluation was anticipated, such financing was in heavy demand, rising by a staggering 150 percent in the first half of 1975 alone. With the introduction in the second half of the year of the creeping devaluation, which drove up the price of credit to the importer, and with the plateauing of world raw material prices, the volume of such financing plummeted 40 percent to stand at IL950 million by year's end. The downturn is explained by the diminishing worthwhileness of such credit, as well as an administrative change in policy, which in the past encouraged the buildup of imported raw material stocks.

Foreign currency credit granted according to specific approvals fell 4 percent in the course of the year, and totaled IL1.5 billion by the end of December.

Table XVII-9

OUTSTANDING CREDIT GRANTED TO THE GOVERNMENT BY THE BANKING SYSTEM, 1973-75

(IL million)

| | From the Bank of Israel | | | From banking institutions | | | |
|-----------|--|--|-----------------|-----------------------------|---|---|-------------------|
| | Credit granted to the govt. ^a | Increase in govt. and National Institution deposits ^b | Net total (1-2) | Credit granted to the govt. | Investment in govt. securities ^c | Increase in govt. deposits ^d | Net total (4+5-6) |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
| 1973 | 5,424 | 1,871 | 3,553 | 624 | 823 | 77 | 1,370 |
| 1974 | 6,712 | 457 | 6,255 | 886 | 981 | 228 | 1,639 |
| 1975 | | | | | | | |
| January | 7,063 | 689 | 6,374 | 838 | 942 | 199 | 1,589 |
| February | 7,012 | 597 | 6,415 | 899 | 978 | 203 | 1,675 |
| March | 5,285 | 496 | 4,789 | 898 | 1,064 | 190 | 1,772 |
| April | 6,099 | 588 | 5,511 | 990 | 1,050 | 124 | 1,915 |
| May | 6,603 | 626 | 5,977 | 996 | 1,131 | 104 | 2,023 |
| June | 6,840 | 538 | 6,302 | 924 | 1,173 | 133 | 1,964 |
| July | 6,318 | 655 | 5,663 | 753 | 1,190 | 114 | 1,829 |
| August | 6,964 | 570 | 6,394 | 772 | 1,192 | 108 | 1,856 |
| September | 7,010 | 513 | 6,497 | 856 | 1,326 | 111 | 2,071 |
| October | 7,908 | 503 | 7,405 | 818 | 1,256 | 132 | 1,942 |
| November | 8,161 | 496 | 7,665 | 815 | 1,246 | 111 | 1,950 |
| December | 7,831 | 474 | 7,357 | 1,138 | 1,367 | 147 | 2,358 |

^a Includes the monthly debits to the government's account for Bank of Israel profits transferred to the Treasury; IL 185 million in devaluation losses have been deducted from total profits.

^b Includes the Bank of Israel's capital and the "other accounts" item in its balance sheet.

^c Excludes treasury bills and the banks' Short-Term Loan holdings.

^d 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.

(c) *Bank Credit to the Government*²²

Gross Bank of Israel credit to the government went up IL1.1 billion during 1975 to hit IL7.8 billion. The growth pattern over the year was influenced by the general liquidity position of the government, and can hardly be linked to any specific government action. Nevertheless, there were two prominent developments: a steep drop in the government's debt toward the end of March, when it had to repay all its provisional advances to the Bank of Israel; and a rise in the government's debt in October, when it had to redeem a large volume of government bonds.

In 1975 the government did not take on any long-term advances, and all the increase in its indebtedness to the central bank stemmed from the growth of provisional advances. In fact, the government repaid IL132 million on account of long-term advances obtained previously, in addition to IL10 million in linkage differentials on such liabilities.²³ By the end of the year outstanding long-term advances amounted to about IL5 billion, with the remaining IL2.8 billion consisting of provisional advances and treasury bills.

It should be stressed that from the monetary aspect no great significance attaches to the amount of Bank of Israel credit received by the government; rather, it is the magnitude of the total government liquidity injection that is important (see sections 1 and 2 above and Chapter XX).

The net sum provided to the government by the banking institutions rose IL720 million this year. Roughly half the increment represented the appreciation of the government's securities portfolio, with the balance stemming from the IL250 million increase in credit to the government and an IL80 million contraction of the government's deposits.

Broadly, it can be said that the banking institutions supply credit to the government not from their freely loanable resources, but in the form of security purchases, compulsory loans, and special arrangements such as that governing treasury bills, etc. The increase and variations in credit to the government in 1975 originated in bookkeeping transfers of credit from bank subsidiaries to the parent concern and their return flow, in

22. The reference is to credit granted to the government by the banking system, and not to the government's liquidity injection--a subject discussed previously. The difference between the two concepts lies mainly in the government's foreign currency transactions on the one hand and its borrowing from other sources on the other.

23. In December 1975 the method of recording linkage differentials on the government's long-term advances was revised. The government was not charged with some IL700 million in linkage differentials which accrued in 1975 but was not actually paid to the Bank of Israel during the year. The government's long-term advances linked to the dollar are presented in the balance sheet at the rate of \$1=IL6, which was the rate actually in force on December 31, 1974. The change was intended to prevent the recording of unrealized profits of the Bank, which if transferred to the Treasury at the end of the year would have had an expansionary monetary effect. Under the new method linkage differentials are recorded only in the year they are actually paid by the government to the Bank of Israel.

the crediting of banks with the premium paid those putting their money in the new approved savings schemes, etc. The growth of credit to the government at the end of December stemmed, as in the previous year, from the banks crediting on the final day of the year of civil servants' accounts with their pay for the month with a view to window-dressing their balance sheets.

(d) *Foreign Currency Assets*

1. *Holdings in the Bank of Israel*²⁴

Total foreign currency assets of the Bank of Israel shrank by \$26 million to stand at \$1,304 million at year's end; the Bank's foreign currency liabilities went up \$55 million,

Table XVII-10
FOREIGN CURRENCY ASSETS AND LIABILITIES OF THE BANKING SYSTEM, 1974-75

(\$ million)

| | Bank of Israel | | | | Banking institutions | | | | Net assets in banking system (4+8) |
|---------------|------------------------------|--|--------------------------------|--------------------|--------------------------------------|--|--------------------------------|--------------------|------------------------------------|
| | Foreign currency liabilities | | | | Foreign currency liabilities | | | | |
| | Foreign currency assets | Nonresidents' deposits ^a (Patach) | Other liabilities ^b | Net assets (1-2-3) | Foreign currency assets ^c | Nonresidents' deposits ^d (Patach) | Other liabilities ^e | Net assets (5-6-7) | |
| End of period | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| 1974 | 1,330 | 129 | 130 | 1,071 | 1,816 | 931 | 1,169 | -284 | 787 |
| 1975 | | | | | | | | | |
| January | 1,398 | 125 | 130 | 1,143 | 1,481 | 907 | 1,030 | -456 | 687 |
| February | 1,543 | 128 | 144 | 1,271 | 1,430 | 914 | 1,057 | -541 | 730 |
| March | 1,822 | 133 | 144 | 1,545 | 1,321 | 902 | 1,099 | -680 | 865 |
| April | 1,736 | 130 | 145 | 1,461 | 1,282 | 906 | 1,059 | -683 | 778 |
| May | 1,763 | 135 | 144 | 1,484 | 1,304 | 904 | 1,074 | -674 | 810 |
| June | 1,691 | 139 | 161 | 1,391 | 1,335 | 913 | 1,055 | -633 | 758 |
| July | 1,527 | 133 | 162 | 1,232 | 1,403 | 920 | 1,025 | -542 | 690 |
| August | 1,467 | 135 | 160 | 1,172 | 1,404 | 925 | 1,044 | -565 | 607 |
| September | 1,359 | 137 | 161 | 1,061 | 1,424 | 939 | 1,083 | -598 | 463 |
| October | 1,394 | 140 | 161 | 1,093 | 1,435 | 976 | 1,099 | -640 | 453 |
| November | 1,353 | 139 | 171 | 1,043 | 1,416 | 990 | 1,125 | -699 | 356 |
| December | 1,304 | 142 | 172 | 990 | 1,875 | 1,007 | 1,651 | -783 | 207 |

^a Nonresidents' deposits redeposited by the banking institutions with the Bank of Israel.

^b Includes deposits of foreign banks and Israeli currency deposits of the International Monetary Fund.

^c Loans to and deposits with foreign banks and overseas branches of Israeli banks, loans to nonresidents, foreign securities, and coin and currency.

^d Deposits of new immigrants and temporary residents, less Patach deposits redeposited with the Bank of Israel.

^e Deposits of foreign banks and overseas branches of Israeli banks.

24. The term "foreign currency assets" is not identical with "foreign exchange reserves": the former consists of all claims on and obligations to the rest of the world, while the latter consists mainly of liquid claims and obligations.

Table XVII-11
LIQUID ASSETS OF THE PUBLIC, BY SOURCE AND COMPONENT, 1973-75
 (IL million)

| End of period | End-of-year balance | | | Increase in 1975 over corresponding period year before | | | | | | | | |
|--|---------------------|---------------|---------------|--|--------------|---------------------------|--------------|---------------------------|--------------|---------------------------|--------------|---------------------------|
| | 1973 | 1974 | 1975 | April-June | | | July-Sept. | | Oct.-Dec. | | Jan.-Dec. | |
| | | | | Jan.-March | Total change | Devaluation differentials |
| A. Sources | | | | | | | | | | | | |
| Bank of Israel | | | | | | | | | | | | |
| Foreign currency assets, net | 7,398 | 6,428 | 7,030 | 2,840 | -757 | 168 | 1,085 | 978 | -396 | 104 | 602 | 1,250 |
| Credit to the govt., net | 3,793 | 6,495 | 7,597 | -1,466 | 1,513 | 5 | 195 | 192 | 860 | 28 | 1,102 | 195 |
| Rediscounts for the Jewish Agency | 354 | 380 | 301 | -47 | -9 | 6 | -9 | 40 | -14 | 4 | -79 | 50 |
| Rediscounts, liquidity exemptions, and local and foreign currency loans to the public ^a | 1,862 | 4,759 | 6,223 | -707 | 558 | 43 | 1,141 | 370 | 472 | 46 | 1,464 | 459 |
| Open-market operations | -400 | -14 | 239 | 40 | -102 | 0 | 142 | 0 | 173 | 0 | 253 | 0 |
| Total | 13,007 | 13,048 | 21,390 | 660 | 1,203 | 222 | 384 | 1,550 | 1,095 | 182 | 3,342 | 1,954 |
| Banking institutions | | | | | | | | | | | | |
| Foreign currency assets, net | 56 | -1,708 | -5,560 | -2,377 | 213 | -81 | -319 | -514 | -1,369 | -70 | -3,852 | -665 |
| Credit to the govt. in IL, net | 1,370 | 1,639 | 2,358 | 133 | 192 | 0 | 107 | 0 | 287 | 0 | 719 | 0 |
| Credit to the public | | | | | | | | | | | | |
| Nondirected credit in IL | 4,067 | 5,434 | 7,072 | 641 | -92 | 0 | 677 | 0 | 412 | 0 | 1,638 | 0 |
| Directed credit in IL (excl. rediscounts and liquidity exemptions) | 1,102 | 871 | 1,294 | 132 | 106 | 0 | 166 | 0 | 19 | 0 | 432 | 0 |

| | | | | | | | | | | | | |
|--|---------------|---------------|---------------|--------------|--------------|------------|--------------|--------------|--------------|------------|--------------|--------------|
| Foreign currency credit to the public (excl. rediscounts and liquidity exemptions) | 1,733 | 3,381 | 5,367 | 1,250 | 480 | 103 | -35 | 649 | 291 | 75 | 1,986 | 827 |
| Total | 8,391 | 9,617 | 10,531 | -221 | 899 | 22 | 596 | 135 | -360 | 5 | 914 | 162 |
| Other factors, net | -931 | 1,047 | 4,837 | 1,451 | 119 | -1 | 800 | -4 | 1,420 | 11 | 3,790 | 6 |
| Total sources | 20,467 | 28,712 | 36,758 | 1,890 | 2,221 | 243 | 1,780 | 1,681 | 2,155 | 198 | 8,046 | 2,122 |
| B. Components | | | | | | | | | | | | |
| Money supply | 7,392 | 8,722 | 10,614 | 865 | 467 | 0 | 239 | 0 | 321 | 0 | 1,892 | 0 |
| Less-liquid deposits in local and foreign currency ^b | 13,075 | 19,900 | 26,144 | 1,025 | 1,754 | 243 | 1,541 | 1,681 | 1,834 | 198 | 6,154 | 2,122 |
| Total components | 20,467 | 28,712 | 36,758 | 1,890 | 2,221 | 243 | 1,780 | 1,681 | 2,155 | 198 | 8,046 | 2,122 |
| Short-Term Loan held by the public ^c | 377 | 162 | 83 | -8 | 43 | 0 | -37 | 0 | -77 | 0 | -79 | 0 |

^a Excludes rediscounts for banks.

^b Excludes the Short-Term Loan.

^c Excludes certificates held by banking institutions.

SOURCE: Bank of Israel.

so that its net asset balance fell by \$81 million, from \$1,071 million at the end of 1974 to \$990 million. The public's purchases of foreign currency from the central bank far surpassed the 1974 volume (see section 3a), but much of the resulting net reduction in assets was offset by \$230 million of government foreign currency transfers, the receipt of \$200 million in international financial institution loans, and a \$110 million profit from the investment of the Bank's foreign exchange reserves.

Developments during the year were not uniform. In the first three months there was a temporary, seasonal strong upsurge in net foreign currency assets, as the November 1974 devaluation continued to make its impact felt and induced the private sector to sell foreign currency to the Bank of Israel. There was also a heavy volume of government foreign currency transfers. The net outcome was the swelling of the Bank's foreign currency assets by \$474 million in the first quarter. In April the level turned downward, and it continued to drop steadily until it reached \$990 million by year's end. It should be noted that the changes in foreign currency asset holdings do not necessarily indicate their monetary implications, for not all the purchases and sales of foreign currency were made in Israeli currency (on the monetary aspect of the fluctuations in foreign currency holdings see section 3a).

2. *Commercial bank holdings*²⁵

The year reviewed saw a steep jump in the commercial banks' net liabilities to the foreign sector, which reflected the economy's growing reliance on the banks for procuring funds from overseas sources. Net claims of the foreign sector on Israeli banks rose by \$499 million to \$783 million. There was a precipitate jump in liabilities without a corresponding growth of assets, a reflection of the inflow of foreign currency credit from abroad for onlending to local clients.

Of the total increment of some \$500 million in the economy's borrowed receipts, the government took about \$250 million, with the rest going to other economic units (including the private sector, nonprofit institutions, and local authorities). This has important implications for an analysis of both the banking system's foreign currency reserves and the amount of credit made available to the various economic units. No clearcut distinction can be made between the economic implications of credit granted in Israeli currency and that in foreign currency, for balance of payments transactions may be financed with Israeli currency credit, and conversely foreign currency credits may be used for financing

25. Consists of the commercial banks' net claims on the foreign sector, and not the foreign currency balances of the banks themselves.

domestic activity, either after conversion into local currency or for paying for imports. It should be stressed that the large-scale flow of credit to local borrowers began in 1974, at the beginning of which year the banking institutions owned \$13 million in net claims on the foreign sector, whereas by year's end it was a net debtor to the tune of \$284 million.

In this connection it should be stressed that when the banking institutions' obligations to the foreign sector exceed their claims, this does not necessarily mean that they are in a deficit position, and certainly it should not be construed as a deficit in their balance of linked assets and liabilities (see section 5). It merely implies a deficit with respect to the foreign sector alone, which as far as the banking institutions are concerned, is offset by a surplus of foreign currency claims on economic units in Israel.

The contraction of the banks' net foreign currency holdings took place mostly in the first quarter of the year, when the Bank of Israel's foreign exchange reserves swelled; as a consequence, the net foreign currency holdings of the banking system as a whole grew by \$78 million during this period. The economic units hardly resorted to foreign currency financing during the rest of the year, and especially in the second half, because of the sharp rise in the price of such credit relative to that of IL credit. In December net obligations soared \$84 million, with both assets and liabilities rising strongly; but as already explained, this merely constituted window-dressing of the banks' balance sheets at the end of the year.

4. COMPONENTS OF THE MONETARY EXPANSION

(a) *The Money Supply*

During 1975 the quantity of money increased by IL1.9 billion, or 21.6 percent, and totaled IL10.6 billion; this compares with an 18 percent rise the year before. The annual average growth was 31 percent, as against 20 percent in 1974. Most of the expansion took place in the first half of the year reviewed, when the level rose 15.2 percent, whereas in the second half the advance came to only 5.5 percent. The variations in the demand for money holdings were apparently connected with variations in the nominal volume of economic activity, i.e. the amount of liquidity which the economic units wished to hold was adjusted to the volume of their activity, allowing for the probable rise in prices and changes in the public's financial assets portfolio. Total resource use was up 39 percent this year in nominal terms, and prices advanced much more moderately than last year;

Table XVII-12
THE MONEY SUPPLY, 1974-75

(IL million)

| End of period | Currency | | Demand deposits | | Money supply | | Money supply, seasonally adjusted | | Share of currency in money supply ^a (%) |
|---------------|----------|--------------------------|-----------------|--------------------------|--------------|--------------------------|-----------------------------------|--------------------------|--|
| | Total | Percent monthly increase | Total | Percent monthly increase | Total | Percent monthly increase | Total | Percent monthly increase | |
| 1974 | 3,175 | 1.9 | 5,549 | 6.8 | 8,722 | 5.0 | 8,740 | 4.0 | 36.3 |
| 1975 | | | | | | | | | |
| January | 3,242 | 2.2 | 5,560 | 0.2 | 8,802 | 0.9 | 8,927 | 2.1 | 36.8 |
| February | 3,467 | 6.9 | 5,864 | 5.5 | 9,331 | 6.0 | 9,570 | 7.2 | 37.2 |
| March | 3,661 | 5.6 | 5,926 | 1.1 | 9,587 | 2.7 | 9,568 | 0.0 | 38.2 |
| April | 3,687 | 0.7 | 5,947 | 0.4 | 9,634 | 0.5 | 9,740 | 1.8 | 38.3 |
| May | 3,672 | -0.4 | 6,168 | 3.7 | 9,840 | 2.1 | 9,929 | 1.9 | 37.3 |
| June | 3,691 | 0.5 | 6,363 | 3.2 | 10,054 | 2.2 | 9,973 | 0.4 | 36.9 |
| July | 3,726 | 0.9 | 6,114 | -3.9 | 9,840 | -2.1 | 9,811 | -1.6 | 38.2 |
| August | 3,931 | 5.5 | 6,352 | 3.9 | 10,283 | 4.5 | 10,355 | 5.5 | 38.2 |
| September | 3,930 | 0.0 | 6,363 | 0.2 | 10,293 | 0.1 | 10,091 | -2.5 | 38.2 |
| October | 3,960 | 0.8 | 6,451 | 1.3 | 10,411 | 1.1 | 10,380 | 2.9 | 38.0 |
| November | 3,876 | -2.1 | 6,388 | -1.0 | 10,265 | -1.4 | 10,172 | -2.0 | 37.8 |
| December | 3,970 | 2.4 | 6,644 | 4.0 | 10,614 | 3.4 | 10,355 | 1.8 | 37.4 |

^a Money supply unadjusted for seasonality.
SOURCE: Bank of Israel.

therefore, the money supply might have been expected to expand by more than a 31 percent annual average, considering the amount of liquidity required for effecting the transactions. However, in the face of the mounting demand for linked assets, particularly those denominated in foreign currency, demand for money fell off. This trend became more pronounced with the introduction of the creeping devaluation in June and the renewal of heavy foreign currency purchases. The steep rise in real interest rates also induced a more economical use of money. Thus, whereas the money supply expanded at a 30 percent annual (seasonally adjusted) rate during the first half of the year, it drifted up at an 8 percent annual rate in the second half. This pattern diverged from that in the previous year, when the money supply (seasonally adjusted) contracted during the first six months, and swelled at a 46 percent annual rate the rest of the year because of an opposite trend in the demand for foreign currency assets.

As a result of these developments, real money balances continued to fall this year, the money supply rising 21.6 percent compared with a 23.5 percent price advance; at annual average rates the decline was even sharper; the money supply increasing 31 percent as against 39 percent in prices. But the 6 percent annual average drop in real money balances this year was still lower than in 1974 (14 percent). The downturn in the real level of the money supply during the past two years was a new phenomenon for the Israeli economy. In each of the three preceding years (1971-73) the annual average real balance rose, with the total increase for this period coming to 31.5 percent; in the last two years, however, the level fell 19 percent (on the economic significance of this development see section 1 above).

Table XVII-13

OTHER LIQUID ASSETS OF THE PUBLIC, 1973-75

(IL million)

| End of period | Time deposits in IL | Short-Term Loan | Total unlinked interest-bearing assets (1+2) | Approved savings schemes ^a | Linked long-term deposits | Deposits against liabilities | Deposits linked to and denominated in foreign currency ^b | | | Free and restricted accounts ^{b,d} | Grand total |
|---------------------------|---------------------|-----------------|--|---------------------------------------|---------------------------|------------------------------|---|-------|--------------------|---|-------------|
| | | | | | | | Pazak restitution | Taman | Other ^c | | |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) |
| 1973 | 3,825 | 377 | 4,202 | 2,437 | 0 | 88 | 2,960 | 1,781 | 1,269 | 705 | 13,452 |
| 1974 | 3,601 | 162 | 3,763 | 4,734 | 0 | 108 | 5,177 | 3,138 | 1,879 | 1,314 | 20,113 |
| 1975 | | | | | | | | | | | |
| January | 3,617 | 177 | 3,794 | 4,965 | 0 | 122 | 5,162 | 3,228 | 1,982 | 1,262 | 20,515 |
| February | 3,657 | 173 | 3,830 | 5,233 | 0 | 128 | 5,513 | 3,353 | 1,828 | 1,175 | 21,060 |
| March | 3,550 | 154 | 3,704 | 5,618 | 0 | 122 | 5,464 | 3,345 | 1,860 | 1,056 | 21,169 |
| April | 3,632 | 187 | 3,819 | 5,860 | 0 | 135 | 5,379 | 3,343 | 1,877 | 1,050 | 21,462 |
| May | 3,630 | 200 | 3,830 | 6,177 | 0 | 123 | 5,514 | 3,398 | 1,892 | 1,153 | 22,086 |
| June | 3,579 | 197 | 3,776 | 6,671 | 0 | 146 | 5,686 | 3,495 | 2,030 | 1,162 | 22,966 |
| Devaluation differentials | 0 | 0 | 0 | 0 | 0 | 0 | 111 | 69 | 39 | 24 | 243 |
| July | 3,548 | 192 | 3,740 | 6,830 | 18 | 119 | 5,308 | 3,193 | 2,006 | 1,193 | 22,407 |
| August | 3,615 | 182 | 3,797 | 6,964 | 26 | 131 | 5,420 | 3,259 | 2,115 | 1,220 | 22,932 |
| Devaluation differentials | 0 | 0 | 0 | 0 | 0 | 0 | 103 | 63 | 41 | 23 | 230 |
| September | 3,644 | 160 | 3,804 | 7,188 | 25 | 128 | 5,939 | 3,609 | 2,424 | 1,352 | 24,470 |
| Devaluation differentials | 0 | 0 | 0 | 0 | 0 | 0 | 616 | 396 | 290 | 149 | 1,451 |
| October | 3,604 | 134 | 3,738 | 7,427 | 40 | 124 | 6,214 | 3,792 | 2,568 | 1,359 | 25,262 |
| November | 3,560 | 106 | 3,666 | 7,626 | 53 | 111 | 6,194 | 3,781 | 2,636 | 1,462 | 25,529 |
| Devaluation differentials | 0 | 0 | 0 | 0 | 0 | 0 | 88 | 54 | 37 | 19 | 198 |
| December | 3,561 | 83 | 3,644 | 7,915 | 56 | 125 | 6,312 | 3,879 | 2,646 | 1,650 | 26,227 |

^a The data in this column do not include IL 4.6 billion in linkage differentials at the end of 1975. About 2 percent of the monthly balances consisted of linked time deposits and the Treasury premium paid to savers, totalling IL 203 million at the end of 1974 and IL 433 million at the end of 1975.

^b Includes foreign currency valuation adjustments.

^c Nonrestitution Pazak accounts, Natad, diamond accounts, foreign currency deposits of mortgage banks and investment companies, and unclassified deposits.

^d Pamaz foreign currency accounts of banks, Hay import deposits, and restricted accounts.

The proportion of currency in the total money supply edged down fractionally this year, from a 38 percent annual average in 1974 to 37.7 percent. The level held fairly steady throughout most of the year reviewed, which implies that the credit and money supply multipliers held steady.

(b) *Other Liquid Assets of the Public*

Other liquid assets of the public (IL time deposits, the Short-Term Loan, foreign currency deposits, and bank-administered savings schemes) expanded during the year by 19.8 percent (before revaluation). In addition, owners of such assets were credited with linkage differentials due to the rise in the consumer price index and the devaluation of the IL, so that in all such holdings rose 36 percent to IL30.8 billion.

This group of assets is very heterogeneous, and the various components did not move in the same direction during the year. Demand for unlinked assets continued to flag in 1975, and their balance dropped 3 percent; by contrast, in the case of approved savings schemes demand continued to be ebullient, and the balance of such accounts shot up 67 percent (before revaluation). Foreign currency deposits hardly expanded this year, apart from accrued linkage differentials, but this was due primarily to the administrative restrictions imposed on such accounts rather than to optimal portfolio selection considerations of the general public.

1. *Pazak and Tamam accounts*

The behavior of recipients of current restitutions and veteran owners of Pazak and Tamam accounts was influenced by several factors this year, the main ones being the volume of restitution receipts, changes in the external value of the world's major currencies, and the initiation of a system of creeping devaluation in Israel. Restitution receipts from West Germany soared from \$245 million (IL1,320 million) in 1974 to \$340 million (IL2,283 million), with interest income on existing deposits reaching IL460 million. Owners of such accounts were also credited with IL1.5 billion in devaluation differentials, but the weakening of the Deutsche mark and various other exchange rate changes shaved off some IL700 million from the balances. The total potential growth therefore came to IL3.5 billion,²⁶

The actual growth of these deposits, however, came to only IL1,876 million. The IL1,640 million difference was converted into Israeli currency, either directly at the Bank of

26. According to the rates of exchange in force on the dates when the accounts were credited.

Israel or through the sale of foreign currency to the Natad dollar market.²⁷ The ratio between conversions and current income (restitution proceeds and accrued interest) dropped from 71 percent in 1974 to 60 percent, but relative to the total change in the assets portfolio (including devaluation and exchange rate differentials), conversions doubled this year from 24 to 47 percent. This development (which restored the figure to its 1973 level) was apparently due to the inordinately low rate of conversions before the November 1974 devaluation, when the public thought such a move was on the cards.

Table XVII-14
ESTIMATED CONVERSION OF PAZAK RESTITUTION AND TAMAM FUNDS,^a 1973-75
(IL million)

| | Personal restitution | Interest on Pazak and Tamam | Exchange rate and linkage differentials | Total potential increase (1+2+3) | Actual increase | Amount converted into IL (4-5) | Rate of conversion (%) | |
|-----------|----------------------|-----------------------------|---|----------------------------------|-----------------|--------------------------------|------------------------|--------------------------|
| | | | | | | | A ^b (6÷4) | B ^c (6/[1+2]) |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| 1973 | 1,102 | 238 | 665 | 2,005 | 1,164 | 841 | 42 | 63 |
| 1974 | 1,320 | 290 | 3,092 | 4,702 | 3,564 | 1,138 | 24 | 71 |
| 1975 | 2,283 | 460 | 797 | 3,540 | 1,876 | 1,664 | 47 | 60 |
| January | 162 | 41 | 206 | 409 | 236 | 173 | 42 | 85 |
| February | 199 | 49 | 214 | 462 | 315 | 147 | 32 | 59 |
| March | 231 | 59 | -200 | 90 | -57 | 147 | 163 | 51 |
| April | 214 | 28 | -120 | 122 | -87 | 209 | 171 | 86 |
| May | 179 | 38 | 91 | 308 | 190 | 118 | 38 | 54 |
| June | 211 | 36 | 167 | 414 | 269 | 145 | 35 | 59 |
| July | 157 | 25 | -738 | -556 | -682 | 126 | -23 | 69 |
| August | 131 | 25 | 161 | 317 | 180 | 137 | 43 | 88 |
| September | 197 | 42 | 727 | 966 | 869 | 97 | 10 | 40 |
| October | 160 | 41 | 369 | 570 | 458 | 112 | 20 | 56 |
| November | 165 | 27 | -114 | 78 | -31 | 109 | 140 | 57 |
| December | 277 | 49 | 34 | 360 | 216 | 144 | 40 | 44 |

^a The data relate to Pazak restitution funds and Tamam, but not to other Pazak accounts.

^b This calculation assumes that the recipients treat exchange rate differentials in the same manner as restitution receipts and interest on Pazak and Tamam accounts.

^c This calculation assumes that the recipients treat exchange rate differentials as capital gains on the deposits.

SOURCE: Personal restitution receipts and exchange rate and devaluation differentials—Foreign Exchange Department, Ministry of Finance; interest on Pazak and Tamam—Bank of Israel; actual increase—Bank of Israel.

This year too the latent "time bomb" which these deposits represented failed to burst; that is, there was no large-scale conversion of Pazak and Tamam deposits (including current restitution receipts) into Israeli currency. These deposits have been expanding from year to year, and at the end of 1975 reached IL12.8 billion. In actual fact the

27. For a description of the Natad market see Chapter XIX, "The Securities Market".

likelihood of such an "explosion" has decreased with the changeover to a system of creeping devaluation, because of the heightened prospect of earning a profit, especially in the short run, and the diminished element of uncertainty. Nevertheless, the fact that this asset is not tradable poses a problem, for only a few population groups in the upper age brackets will continue to hold such deposits.²⁸

The pattern of conversions during the year generally resembled that of devaluation expectations and hence the demand for foreign currency assets. This demand was fairly weak in the first months of the year, picking up during the second half.

2. *Unlinked liquid assets*

The year reviewed was the third consecutive one to see a decline in unlinked liquid asset holdings (time deposits and the government Short-Term Loan). As regards households, this reflected the growing reluctance to hold such assets during a period of rapid inflation, when the nominal interest rate does not adjust to the changes in the price level. From the standpoint of the banking institutions this has had other implications, notably the fact that time deposits, which for many years were the predominant source of the banks' freely loanable funds, have declined in importance. Whether such deposits could have been mobilized to a significantly greater extent by bringing the interest rates into line with the rate of inflation is a moot point. The banks have refrained from doing this, preferring to maintain the existing deposit arrangements while creating an additional framework for unlinked deposits paying a higher interest (see the discussion of the buy-back agreements below). In this manner they have reduced the marginal cost of raising new deposit money and created two frameworks: one for regular depositors, paying a low rate of interest, and the second for more sophisticated depositors, paying a higher interest. There is no way of directly identifying the two categories, but an examination of the data on the balance and debits to such accounts shows the regular saving public to be fairly stable; in most cases their deposits are renewed upon maturity, but very few newcomers join their ranks.

In recent years a new form of bank intermediation sprang up which has enabled big depositors to earn a higher interest; the reference is to the buy-back agreements under which banks pay varying rates of interest to holders of time deposits, depending on the bargaining power of the latter and the alternative instruments available to them. The commercial bank and the depositor (generally a large one) come to an agreement over the period of the deposit and the rate of interest, which as a rule exceeds the going rate

28. The reference is mainly to Pazak restitution and Tamam.

paid to regular depositors. As far as the client is concerned, the transaction takes the legal garb of a securities purchase from the bank, with the contract stipulating the date and price of the resale to the bank. This device in effect permits the receipt of time deposits while sidestepping the liquidity regulations, as well as greater flexibility with respect to the period of the deposit and the payment of a relatively high rate of interest without affecting that paid on regular time deposits; there are apparently also some advantages as regards taxation. The Bank of Israel closed this arrangement to new depositors at the end of 1975, when it required the banks to report on such accounts and imposed a liquidity ratio thereon.

No reliable data are available on the volume of such buy-back transactions, but cautious estimates put it at IL600-700 million for 1975. This should be added to the figures on unlinked liquid assets of the public in order to get a complete picture of such holdings. Toward the end of the year, with the imposition of the reporting and liquidity requirements, the volume of such business dropped dramatically, and at year's end the balance stood at only IL170 million. The popularity of this arrangement supports the argument that even during an inflationary period unlinked liquid assets can be sold to sophisticated investors if the interest rate is adjusted to the inflationary expectations and the deposit term to the clients' requirements.

Ordinary time deposits slumped by IL40 million to IL3,560 million. The movement of Short-Term Loan sales over the year also reflected the failure to modify the yield in line with developments in the economy in general and the money market in particular. In the early months of 1975 the outstanding balance of loan certificates held fairly steady at about IL170 million, but in May it jumped to IL200 million after the yield had been raised by one point in the previous month; subsequently the curve tailed off and by year's end it stood at a mere IL80 million. In this situation the loan can hardly be regarded as an effective instrument for the conduct of monetary policy. As regards its properties as a financial asset, the Short-Term Loan has an edge over a time deposit, and the fact that the volume of time deposits is forty times as great as Short-Term Loan holdings is further proof of the banks' ability to sway the saving public and influence its financial assets portfolio selection.

3. Approved savings schemes and linked long-term deposits

Approved savings schemes continued to expand strongly in the year reviewed, by IL3.2 billion, or 67 percent, to reach IL12.5 billion (including accrued linkage differentials). This formidable figure makes this savings medium a front-rank household financial asset;

Table XVII-15
ASSETS AND LIABILITIES OF BANKING INSTITUTIONS, 1974-75^a

(IL million)

| End of period | 1974 | | | | 1975 | | | |
|---|---------------------|---|---------------------|---------------|---------------------|---|---------------------|----------------|
| | Israeli currency | Index- linkage differ- entials | Foreign currency | Total | Israeli currency | Index- linkage differ- entials | Foreign currency | Total |
| Assets | | | | | | | | |
| Liquid IL assets at the Bank of Israel ^b | 3,716 | — | — | | 3,254 | — | — | |
| Foreign currency deposits with the Bank of Israel | — | — | 10,306 | | — | — | 12,878 | |
| Loans and deposits abroad | — | — | 10,725 | | — | — | 13,311 | |
| Nondirected credit | 5,434 | 127 | — | | 7,072 | 260 | — | |
| Participation in directed credit | 1,898 | 56 | 3,422 | | 2,539 | 89 | 5,431 | |
| Credit to the public from ear- marked deposits | 5,431 | 2,714 | — | | 8,006 | 4,789 | — | |
| Credit to the public from govt. deposits | 2,735 | 38 | — | | 4,248 | 55 | — | |
| Securities of Israeli companies and institutions | 3,428 | 1,475 | 34 | | 5,607 | 2,734 | 95 | |
| Premises and equipment | 568 | — | — | | 793 | — | — | |
| Loans to the govt. from the banks' own means | 935 | 375 | 350 | | 1,187 | 995 | 1,625 | |
| Government bonds ^c | 982 | 611 | — | | 1,368 | 826 | — | |
| Loans to the govt. from earmarked deposits | 6,056 | 3,518 | 1,265 | | 9,254 | 7,032 | 2,438 | |
| Cash items in process of collection and banking institution deposits | 565 | 189 | 805 | | 612 | 225 | 1,227 | |
| Other accounts | 2,407 | 30 | 399 | | 2,989 | 117 | 483 | |
| Sundry accounts ^d | 2,278 ^e | 22 ^e | 2,535 ^f | | 3,434 ^e | 140 ^e | 3,500 ^f | |
| Contingent accounts ^g | 2,719 | 58 | 4,202 | | 4,371 | 136 | 5,827 | |
| Total assets^h | 39,152 | 9,213 | 34,043 | 82,408 | 54,734 | 17,398 | 46,815 | 118,947 |

| Liabilities | | | | | | | | |
|--|--------------------|-----------------|--------------------|--------------------|------------------|--------------------|---------------|----------------|
| Equity capital and capital notes | 2,099 | — | 161 | 2,947 | 16 | 176 | | |
| Foreign deposits ⁱ | — | — | 12,666 | — | — | 18,872 | | |
| Rediscounts | 174 | 1 | — | 207 | 1 | — | | |
| Demand deposits | 5,549 | — | — | 6,644 | — | — | | |
| Time deposits | 3,628 | 41 | — | 3,561 | 30 | — | | |
| Approved savings schemes | 4,736 | 2,507 | — | 7,915 | 4,617 | — | | |
| Linked long-term deposits | — | — | — | 56 | — | — | | |
| Foreign currency deposits of the public | — | — | 11,518 | — | — | 14,487 | | |
| Approved earmarked deposits | 11,224 | 6,618 | 79 | 16,736 | 12,268 | 51 | | |
| Earmarked govt. deposits ^j | 2,834 | 13 | 38 | 4,366 | 17 | 12 | | |
| Government accounts ^k | 277 | 2 | 1,111 | 197 | 2 | 1,465 | | |
| Banking institution deposits and cash items in process of collection | 719 | 161 | 796 | 883 | 296 | 1,323 | | |
| Other accounts | 3,074 | 30 | 502 | 3,847 | 6 | 411 | | |
| Sundry accounts ^d | 2,333 ^l | 22 ^l | 2,516 ^m | 3,601 ^l | 140 ^l | 3,463 ^m | | |
| Contingent accounts ^e | 2,719 | 28 | 4,202 | 4,371 | 136 | 5,827 | | |
| Total liabilities^h | 39,366 | 9,453 | 33,589 | 82,408 | 55,331 | 17,529 | 46,087 | 118,947 |

^a A new series; the balance sheet published by the Department of the Examiner of Banks has been adjusted to conform to the definitions in this chapter.

^b IL deposits with the Bank of Israel treated as a liquid asset, treasury bills, and currency and coin.

^c Includes the Short-Term Loan.

^d Includes all the adjustments mentioned in note ^a.

^e IL rediscounts for the public (before deducting deposits).

^f Foreign currency rediscounts for the public (before deducting deposits, rediscounts for the Jewish Agency, and Patach funds deposited with the Bank of Israel (as reported by the banking institutions).

^g Acceptances, guarantees, and documentary credits.

^h The breakdown of the total differs from that in the balance sheet published by the Department of the Examiner of Banks, since in this table rediscounts and credit to the public in the Export Shipments Fund are treated as Israeli currency credit, and deposits in the import funds are treated as foreign currency deposits.

ⁱ Deposits of foreign banks and overseas branches of Israeli banks, nonresidents, new immigrants, and temporary residents, less deposits with the Bank of Israel.

^j Utilized earmarked deposits.

^k Demand, time, and unutilized earmarked government deposits.

^l As in note ^e, plus deposits against liabilities, demand deposits of the public in the Israel Bank of Agriculture, and the difference between earmarked government and Jewish Agency deposits as recorded in the banks' liquidity report and in the monthly balance sheet.

^m As in note ^f, but with Patach funds according to Bank of Israel data.

it is surpassed only by claims on pension and provident funds (which are very long-term assets and of a completely different character). The vigorous upswing of such accounts has persisted since 1973, when a new plan was launched. During most of the 18 preceding years this medium was quite low down in the household assets portfolio.

Two main reasons can be advanced to explain the impressive success of approved savings schemes: the first is the simplicity of such deposits in comparison with an investment in securities, mutual funds, etc., which requires a knowledge of the market and the keeping of close tabs on its development; this is an important consideration for those who are not very familiar with the workings of the market. The second reason is the vigorous plugging of such deposits by the banks, which find them more profitable than other savings media. In marshaling such deposits the banks also enjoy special concessions from the Treasury in the form of a premium. If an objective analysis were made of the entire array of investment outlets open to the public, approved savings schemes probably would not be high up on the list of optimal assets, mainly because of their relative illiquidity, which is not offset by the yield advantage. It may therefore be concluded that the huge success enjoyed by such schemes has been mainly due to the imperfections of the savings market, coupled with the aggressive advertising campaign of the banks designed to persuade savers to put their money in this medium rather than a direct bond investment.²⁹ During the past year, for example, the rumors about a possible worsening of the terms of a direct securities investment induced a shift to bank-administered savings schemes. The Treasury has given a fillip to such schemes by granting depositors a special incentive, over and above the return earned on a direct investment in government bonds. The justification for awarding a premium is the relatively low liquidity of this form of saving, which from the macroeconomic aspect is an advantage. This incentive has been granted since the launching of the new plan in 1973, and it was increased in the latter part of the present year with the reform of the capital market. But the return on approved savings schemes still trails behind that on a bond investment, so that there is really no encouragement to acquire this illiquid asset. Under the capital market reform the indexation of bonds sold directly to the public has been reduced to 90 percent, while those acquired with savings scheme funds have remained fully linked. This of course has enhanced the attraction of the latter.

In July 1975 a new framework was created for deposits of over IL500,000 placed for a period of two and a half years or more. These are subject to a 15 percent liquidity ratio, which is lower than that on ordinary time deposits, and index-linked government bonds

29. The approved savings schemes have been the most widely advertised of the various saving-investment media offered by the banks.

tradable on the exchange are deemed to be a liquid asset for this purpose. The new framework was created in order to permit a differentiation between deposits earmarked for the granting of medium-term loans (which do not require liquid asset cover) and ordinary medium-term deposits.

5. THE BANKING INSTITUTIONS' BALANCE SHEET

The combined balance sheet of the banking institutions increased 44 percent in 1975 to reach IL119 billion;³⁰ of this, approximately IL73 billion (including some IL17 billion in index-linkage differentials) was in Israeli currency and IL46 billion in foreign currency. The Israeli currency items went up 21 percent in real terms, and those in foreign currency by 16 percent.

The most salient changes in the Israeli currency items were the growth of earmarked loan deposits from IL17.8 billion to IL29 billion and the expansion of approved savings scheme balances from IL7.2 billion to IL12.5 billion (both items are linked to the consumer price index). There was also a notable increase in equity capital, from IL2.1 billion to IL3 billion. Liquid assets held with the Bank of Israel decreased from IL3.7 billion to IL3.3 billion, due to the plunging of the banks into large liquidity deficiencies and the growth of credit to the public and the government from approved deposits. The latter reflected the channeling of financial institution credit to the public through the banks as part of the effort to window-dress their balance sheets.

Among the main developments in the foreign currency items (over and above the revaluation increments due to the devaluation of the IL by a total of 18.3 percent during the year), mention should be made of the stepped up participation of the banking institutions in the provision of directed credit and the large sum lent to the government from the banks' own means and approved deposits alike. On the liabilities side the most striking features were the growth of deposits from abroad and the insignificant increase in local residents' deposits.

A comparison of the banking institutions' foreign currency assets with their foreign currency liabilities shows that the latter were more than covered. On the other hand, the data on accumulated index-linkage differentials do not indicate the accrued balance of such differentials, mainly because they represent accumulated unrealized revaluation increments, and not the balance of assets linked to the consumer price index.

30. This rate is not comparable with that for 1974, since the data for the end of 1973 did not include the appreciation of the various balance sheet items because of indexation. The rate for 1974 therefore reflected not only the balance sheet growth but also the change in recording.