

CHAPTER XIII

MONEY SUPPLY, CREDIT, AND THE BANKING INSTITUTIONS

1. MAIN DEVELOPMENTS

MONETARY EXPANSION was rapid in 1972, but not quite as fast as in the previous year. The money supply rose by IL 1,246 million, or 28.7 percent, compared with 28.2 percent in 1971, while other liquid assets of the public went up more slowly in the year reviewed. Unlinked interest-bearing assets increased 25.6 percent, as against 32.4 percent in 1971; foreign currency deposits of the public—mainly Pazak and Tamam accounts—went up 14.5 percent, as against 50.7 percent (21.1 percent if devaluation differentials are excluded) in 1971; and approved saving scheme balances likewise showed a more sluggish growth.

Total monetary expansion (the increase in the money supply and other liquid assets of the public) came to 22.5 percent, compared with 32.5 percent (26.4 percent exclusive of devaluation differentials) in 1971 (see Table XIII-1).

The main cause of the deceleration was the smaller liquidity infusion in the year reviewed: the money base (currency in circulation plus the banking institutions' liquid assets) expanded by 31.3 percent, as against 43.2 percent in 1971. The slower increase in the amount of liquidity pumped into the economy was due primarily to the absorption of money by the Government and the Bank of Israel, which offset part of the stimulative influence of the foreign currency asset accumulation.

In 1971 there had also been a sizable accumulation of foreign currency assets, while the public's foreign currency deposits swelled in the wake of the devaluation of the Israeli pound; the Government's operations, however, failed to drain off any of the large liquidity infusion that year.

The main expansionary factor in 1972 was, as already mentioned, the accumulation of foreign currency in the Bank of Israel: its net foreign currency asset holdings grew by a total of IL 2,390 million. This was the sole source of the incremental liquidity in 1972, and its sizable dimensions made it one of the major causes of the buoyant demand in the economy, which led to a 15.5 percent rise in resource prices. At the same time, it should be noted that this substantial liquidity inflow was accompanied by a stronger demand for all types of financial assets, real estate, and other existing assets—a development which blunted the

inflationary impact of the increased capital import on prices and the import surplus.

The diversion of demand to financial and existing assets was connected with the higher rate of domestic private saving. But it is also reasonable to assume that an appreciable part of the nongovernmental sector's capital import was intended from the outset for the purchase of such assets.

Table XIII-1
ANNUAL CHANGES IN MAJOR MONETARY AGGREGATES, 1969-72
(IL million)

Year	Balance at end of year	Change in end-year balance		Annual average balance	Change in annual average balance	
		IL m.	%		IL m.	%
Money supply						
1969	2,970	71	2.5	3,015	200	7.1
1970	3,385	415	14.0	3,167	152	5.0
1971	4,341	956	28.2	3,876	709	22.4
1972	5,587	1,246	28.7	5,041	1,165	30.1
Other liquid assets of the public^a						
1969	5,547	991	21.8	5,035	972	23.9
1970	6,848	1,301	23.5	6,206	1,171	23.3
1971	9,222	2,374 ^b	34.7	8,056	1,851	29.8
1972	11,022	1,800	19.5	10,278	2,222	27.6
Total liquid assets of the public^c						
1969	8,517	1,062	14.2	8,050	1,172	17.0
1970	10,233	1,716	20.2	9,373	1,323	16.4
1971	13,563	3,330	32.5	11,932	2,559	27.3
1972	16,609	3,046	22.5	15,319	3,387	28.4
Bank credit to the public^d						
1969	3,860	578	17.9	3,559	528	17.4
1970	4,676	816	21.1	4,211	652	18.3
1971	5,702	1,026 ^e	21.9	5,227	1,016	24.1
1972	6,789	1,087	19.1	6,134	907	17.4

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

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

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

^d Local and foreign currency credit from banking institutions and the Bank of Israel, including bill brokerage. In this Report Bank of Israel credit to the Jewish Agency is not included in credit to the public, but is listed separately.

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

The direct budgetary operations of the Government and the monetary policy of the Bank of Israel were aimed at neutralizing the inflationary effects of the foreign currency accumulation, but they began to show results only in the second half of the year; in the first six months the amount of liquidity pumped into the economy was so large that the intensive absorptive measures of the Government and the Bank of Israel failed to stem its expansion. It was only with the slowing of foreign currency accumulation in the second half of the year and the continued application of restrictive fiscal and monetary measures that the liquidity injection decelerated significantly.

Some idea of the effectiveness of the restrictive measures applied in 1972 may be gained from the following data: whereas foreign currency asset accumulation by the Bank of Israel increased from IL 1,074 million (IL 820 million excluding devaluation increments) in 1971 to IL 2,390 million in 1972, total monetary expansion declined from IL 3,330 million (IL 2,660 million disregarding devaluation increments) to IL 3,046 million.

The Government's absorptive measures were reflected by a decrease of some IL 550 million in its debt to the Bank of Israel and the net purchase of IL 185 million of foreign currency out of domestic revenues,¹ while the Bank of Israel siphoned off some IL 780 million through the raising of liquidity ratios, increasing the participation of commercial banks in the directed credit funds, and by its operations in the open market.

The action taken by the Government and the Bank of Israel kept down the growth of the money supply by 14 percent in each case. In other words, if not for these steps, the money supply would most likely have expanded almost twice as fast as it actually did.²

From the foregoing it is clear that monetary developments in 1972, as in each year since 1968, were decisively affected by the fluctuations in foreign currency accumulation. The reasons for the accelerated accumulation after the devaluation were discussed at length in Chapter III, "The Balance of Payments". Suffice it to observe here that the effect of the devaluation of August 1971 apparently ran its course by the middle of 1972. In the second half of the year foreign currency accumulation declined, and this contributed more than any other factor to the retardation of the monetary expansion.

A comparison of monetary developments in 1972 with those in previous years, as well as between the two halves of 1972, points to a cyclical pattern. It will be recalled that the strong monetary expansion since the Six Day War began in the second half of 1970. Until then the amount of liquidity pumped into the economy was of modest proportions, as the shrinkage of foreign exchange re-

¹ According to another definition of Government absorption, which does not treat the purchase of foreign currency for financing food imports for the home market as an absorptive measure, in 1972 the Government mopped up some IL 14 million, whereas in 1971 it injected about IL 720 million (this is discussed in section 6b below).

² For a fuller discussion see section 3(b) below.

serves offset the expansionary influence of the heavy Government borrowings from the Bank of Israel.

A glance at Table XIII-2 shows that the accelerated liquidity infusion—and rapid growth of other liquid assets of the public—reached its peak in the first half of 1971, while during the second half of that year and the first half of 1972 the pace slackened somewhat. In the second half of the year reviewed the expansion of the money base slowed noticeably, and in the first quarter of 1973 there was even a decline.

In the cyclical pattern displayed by the liquidity infusions since 1970 the Government budget and foreign currency accumulation have played a shifting role. Though there was no increase in foreign exchange reserves in 1970, foreign currency conversions by the nongovernmental sector expanded appreciably, while the Government's heavy foreign currency purchases were financed in a manner that failed to offset the liquidity injected into the economy by the private sector. The situation was aggravated in the first half of 1971, when conversions by the nongovernmental sector continued upward and the Government's operations likewise continued to infuse liquidity. After the devaluation in August 1971, the Government ceased to inject liquidity, and the absorptive fiscal measures it adopted partly counteracted the expansionary impact of the larger capital import by the nongovernmental sector. In the second half of 1972 the uptrend in foreign currency transfers to Israel began to falter, and the further absorption of funds braked the growth of the money base to an appreciable extent. The energetic absorptive measures pursued by the Bank of Israel also helped to dampen the rate of monetary expansion this year.

Table XIII-2

INCREASE IN MONEY BASE, MONEY SUPPLY, AND OTHER UNLINKED ASSETS OF THE PUBLIC, HALF-YEARLY, 1970-72^a

(percentages)

	Money base		Money supply		Time deposits and Short-Term Loan		Money supply and unlinked assets	
	Original data	Seasonally adjusted	Original data	Seasonally adjusted	Original data	Seasonally adjusted	Original data	Seasonally adjusted
1970 I	6.0	3.5	5.1	1.6	11.5	11.4	7.7	5.7
II	12.4	15.1	8.4	11.6	13.9	14.4	10.8	12.8
1971 I	24.6	21.5	14.9	11.7	19.0	18.2	16.7	14.6
II	14.8	17.6	11.6	14.5	11.2	12.1	11.5	13.4
1972 I	21.5	18.6	16.9	14.0	12.4	11.2	12.8	12.8
II	8.1	10.8	10.1	12.8	11.9	13.0	10.7	12.9

^a The money base is defined here broadly, i.e. it consists of currency in circulation and the banking institutions' liquid assets: deposits with the Bank of Israel, treasury bills, exemptions from the liquidity requirements, and authorized liquidity deficits. Other unlinked assets of the public consist of IL time deposits, the Short-Term Loan, and bill brokerage.

The slower expansion of the money base in the second half of 1972 was not fully reflected by a slackening in the growth of other liquid assets held by the public (see Table XIII-2). The reason for this was the much larger volume of credit granted during this period, which permitted a further relatively strong rise in such holdings despite the more sluggish liquidity infusion. The sizable increase in credit was accompanied by a sharp contraction of the banking institutions' free reserves, which carried over through the first quarter of 1973. The banking system moved from a position of substantial liquidity surpluses (evident from mid-1971) to a deficit by the end of 1972, which continued to widen in the first quarter of 1973.³

Despite the laggard liquidity injection in the second half of 1972, activity in the various sectors of the economy continued at a high level, since there is generally a time-lag between a change in the monetary variables and the response of the domestic demands. The big increase in credit resulted, of course, in a much greater lag.

Although the monetary expansion lost vigor in the course of 1972, the annual average balances of the various types of liquid assets rose steeply. The money supply expanded by 30.1 percent, compared with 22.4 percent in 1971, while IL time deposits and Short-Term Loan holdings went up only a shade more slowly than in 1971. All told, these three types of unlinked liquid assets advanced 28.4 percent, compared with 26.4 percent in 1971. The annual average balance of the public's total asset holdings also rose more rapidly in the year reviewed.

The increase in the annual average balance of these three liquid asset groups exceeded the expansion of the national product as well as the economy's available resources at current prices, since part of the sizable incremental liquidity of 1972 was channelled to the existing real asset and financial asset markets, thus diverting some of the potential inflationary pressure from the markets for newly produced goods and services.

The change in the demand destinations led to a relatively moderate increase, relative to the economy's liquidity, in the import surplus and resource prices on the one hand, and to the soaring of security and existing real asset prices and an appreciable growth of the public's financial asset holdings on the other. The decline in the circulation velocity of the money supply relative to GNP and total resources probably reflected not only the generation of excess liquidity but also the bias inherent in this indicator, which does not mirror the huge expansion of activity in existing assets.⁴ The rise in the turnover velocity of demand deposits in 1972, the stability of interest rates, and the liquidity position of the banking institutions reinforce the assumption that the more abundant liquidity this year was accompanied by a heavier demand for money holdings for the

³ It was the additional credit that permitted the relatively large expansion of the public's liquid asset holdings in the final quarter of 1972 and propped up the level in the first quarter of 1973.

⁴ A similar situation developed after the devaluation of the Israeli pound in February 1962.

execution of transactions in existing assets. However, it is also a plausible inference that during this period of rapid monetary expansion, which has persisted since mid-1970, the various sectors of the economy built up liquidity surpluses, as attested by the vigorous nominal growth of economic activity in the last quarter of 1972 and the first quarter of 1973 despite a marked slackening in the pace of monetary expansion. The big increase in interest-bearing liquid asset holdings in 1972 may be ascribed to the stability of rates of return in the economy despite the large liquidity infusion and the mounting demand for such assets. This stability was associated with the policy pursued by the Government and the Bank of Israel concerning administratively fixed yields on value-linked bonds, Pazak and Tamam deposits, etc., and in the case of bank rates, with the rate of interest paid by the Bank of Israel on liquidity surpluses and conditions in the credit market (to be described below).

The development of bank credit to the public in 1972 is explained, as in the previous year, by the large-scale liquidity injection and the abundant long- and medium-term credit made available by the financial institutions—factors which operated mainly in the first eight months of the year, when credit from the banks' free resources increased at a very modest rate. The supply of the latter type of credit was limited during this period by the Bank of Israel's absorptive measures, but the main cause was the subsiding of demand in the various sectors of the economy, as attested by the stabilization of interest rates and the liquidity surpluses run by the banking institutions. The relatively weak demand for such credit is ascribable to its price and the expectation of a rise in the general price level on the one hand, and to the abundant supply of liquidity from other sources on the other.

After the debitory interest rate was upped in the second quarter of 1971 by about 1.5 percentage points (to 18–18.5 percent in the large banks), demand for nondirected bank credit eased and the banking sector began to build up liquidity surpluses—a situation that continued through the third quarter of 1972.

In the second half of the year there was a more buoyant demand for nondirected credit, and it rose at a much stronger rate. This was connected with both the decline in external infusions and the expectation of a further rapid advance of prices. Despite the heavier demand for such credit, debitory interest rates were not raised, but a higher rate was charged for unauthorized overdrafts.

As a result of the livelier demand for nondirected credit in the last six months of 1972, its annual average growth for the year came to 18 percent (3.9 percent in the first half and 13.6 percent in the second half), compared with 15.9 percent in 1971.

A sectoral breakdown of such credit shows a slow increase in that granted to industry, agriculture, construction, and electricity and water, and a rapid increase in that provided to private individuals and the service sectors. It may

therefore be reasonably assumed that the expansion of industrial and agricultural output was mostly financed through an increase in development loans and directed bank credit, by a larger capital import, and from the abundant liquid funds available in the economy. The construction sector is not a recipient of directed bank credit; that total bank credit to this sector rose only slightly despite its high level of activity is therefore explained by the abundant liquidity in the economy and the buoyant demand for the sector's output; the latter resulted in a larger volume of advance payments by home purchasers (private and public),⁵ thereby permitting the further strong expansion of activity.

Short-term directed credit increased more slowly in 1972 than in the previous year—16.1 vs. 23.8 percent. The notable growth of such credit in 1971 was due to the strong gain in exports and the devaluation of the Israeli pound, which appreciated the foreign currency credit balances. In contrast, in 1972 export growth weakened, and steps were taken under the policy of monetary restraint to prevent the excessive expansion of directed credit.

Along with the slower rate of monetary expansion in 1972, there was a striking change in its composition:

1. The growth of Pazak and Tamam accounts sagged noticeably, after swelling appreciably in the previous year because of the revaluation of the German mark and the devaluation of the Israeli pound. The growth of these deposits in 1972 testifies to a strong demand for assets linked to the German mark, though demand for dollar-linked assets subsided considerably. The comparatively brisk demand for DM-linked assets was also reflected in the fact that the rate of conversions of personal restitution receipts was only slightly higher in 1972, despite the notable appreciation of these balances the year before due to the exchange rate changes.

2. The expansion of the option-type saving schemes slowed in 1972, for the third consecutive year. This is explained by the advantages offered by index-linked bonds and bank-administered provident funds.

3. The uptrend in unlinked liquid assets—the money supply, time deposits, and the Short-Term Loan—slowed from 30.1 percent in 1971 to 27.2 percent, with the composition of this group undergoing a change. The money supply expanded at much the same rate as in 1971, but time deposits and Short-Term Loan holdings went up more sluggishly—25.6 as against 32.4 percent. The continued growth of these assets despite the intensification of inflationary expectations indicates their central role in providing the liquid funds required for the execution of transactions in the various markets. The change in the relative shares of the component items—an increase in that of the money supply and a decline in interest-bearing assets—was apparently connected with the structural change in the economy's domestic transactions—viz. an increase in

⁵ The advances paid by the public sector to contractors building homes on public housing projects are reflected in the Government budget and financial institution data.

the proportion of transactions in existing assets, which necessitated the holding of larger money balances. In addition, the more sluggish growth of time deposits and Short-Term Loan certificates probably reflected the switching by some of their holders to assets offering a hedge against inflation.

2. THE INFLUENCE OF MONETARY DEVELOPMENTS ON THE ECONOMY

The main factor behind the rise in the economy's liquidity in 1972 was the unprecedented foreign currency accumulation, in line with the trend begun in the preceding year.

As in 1971, the sizable buildup was made possible by the enormously greater capital import by the nongovernmental sector, which was not accompanied by a similar rise in the balance of payments deficit on current account. The large-scale capital inflow was the principal source of the continued liquidity infusion and resulting demand pressure in 1972. But in contrast to this, the growth of private sector investment and consumption was relatively moderate, despite the abundance of liquidity during most of the year.

Private consumption was up 8.7 percent in 1972; this was a shade less than the growth of private disposable income from domestic sources or total disposable income, indicating a rise in the rate of private saving. In this connection it should be noted that the incremental private saving in the year reviewed consisted overwhelmingly of such financial assets as index-linked bonds, shares, life insurance, provident fund rights, mutual fund participation certificates, Pazak and Tamam deposits, and nonlinked deposits.

Domestic private investment, exclusive of housing and the ships and aircraft item, expanded by 14 percent in 1972, compared with 13 percent the year before. Considering the ample investment financing available in 1972 (from overseas sources as well as from banking and financial institutions), it would seem that it was not the financing factor that precluded a greater investment in the year reviewed.

The influences affecting private consumption and investment in 1972 are discussed in the relevant chapters in this Report. Here we shall merely mention that the comparatively laggard increase in these uses probably suggests that the capital inflow in the year reviewed was of a special nature. Most likely a significant portion of the 1972 capital inflow was channelled to the financial and real markets. In other words, the vigorous level of activity in the share and real estate markets and the buoyant demand for linked financial assets were influenced by the capital import.⁶ But it should be stressed that the higher rate of private saving was an equally important factor.

⁶ As will be explained below, there is reason to believe that the demand for financial assets, fed by part of the incremental capital import, will eventually be reflected in an increased demand for real assets.

It is important to note here that the yields on linked bonds and interest rates held steady in 1972, thus proving an important factor in neutralizing part of the influence of the external liquidity infusion emanating from overseas sources. The bond yields are determined by the Ministry of Finance, while the rates of return on Pazak and Tamam deposits are fixed by the Bank of Israel. Through this system of "floor" rates the Bank helped to prop up bank (debitory and creditory) rates, thereby averting the further stimulation of demand in the economy and the dampening of the public's desire to hold financial assets.

Table XIII-3

INDICATORS OF THE TURNOVER VELOCITY OF LIQUID ASSETS HELD BY THE PUBLIC, 1969-72

	Average velocity of demand deposits ^a	Annual average velocity relative to GNP ^b		
		Money supply	Other liquid assets ^c	Total liquid assets
1969	19.9	5.35	3.20	2.00
1970	21.5	5.99	3.06	2.02
1971	22.8	6.01	2.90	1.96
1972	24.2	5.78	2.87	1.92
		Annual average velocity relative to the economy's resources ^d		
1969		7.71	4.62	2.89
1970		8.44	4.31	2.85
1971		8.66	4.17	2.81
1972		8.46	4.15	2.78

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

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

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

^d The gross national product at current prices, plus the import surplus 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 three aggregates.

One outcome of the greater demand for value-linked assets in 1972 was the creation of a budgetary surplus. This can be mainly credited to the enormously larger Government revenue from its own bond issues and from the proceeds of financial institution issues deposited with the Treasury.

The 30.1 percent increase in the annual average balance of the money supply in 1972 must be viewed against this background. This growth rate far surpassed that of the national product or available resources (at current prices)—a development reflected by the drop in the circulation velocity of the money

supply (see Table XIII-3).⁷ The latter was probably also connected with the aforementioned developments in the financial and existing real asset markets: the demand for such assets was accompanied by an increased demand for money holdings for executing the larger volume of transactions.

The decline in the velocity of money in 1972 cannot be explained merely as a lagged response or attributed to an imbalance in the financial market. To explain it solely as a lagged response seems unreasonable, since the rapid monetary expansion has persisted since the second half of 1970—a fairly long period. The stability of interest rates and the liquidity position of the banking institutions in the first three quarters of 1972 suggest that the money market was not marked by excess liquidity. Had the volume of liquidity pumped into the economy greatly exceeded the demand for liquid assets, this should have been reflected by the swelling of the banking institutions' liquidity surpluses, but there is no evidence that this happened.⁸

A more comprehensive explanation links the rapid growth of money holdings in 1972 with the larger volume of transactions in existing assets. According to this view, part of the public's incremental money holdings was intended for financing current transactions in goods and services, and the remainder for transactions in securities, real estate, commemorative coins, works of art, etc. In other words, the greater preference displayed in the year reviewed for financial and existing real assets led to a rise in the prices of the latter and to an increase in linked financial asset holdings of the public. Moreover, part of the liquidity flowing into the economy was held in the form of money for executing the heavy volume of transactions in these markets.

The large-scale diversion of demand to these markets probably began in 1971 and continued in 1972, but with a change in emphasis: whereas in 1971 the focus was on the real estate market, in 1972 it shifted to securities. This picture was similar to that following the 1962 devaluation, as regards both the rate of expansion of the money supply and the impact of the buoyant demand in the economy on the markets for existing assets.

It is therefore evident that the decline in the circulation velocity of the money supply, or the gap between the demand and supply of money, does not necessarily indicate a change in the propensity to hold liquid assets, but reflects an increase in those transactions excluded from the measurement of the national product or available resources. Because of the lack of data on the changes in the

⁷ Estimates calculated with the help of money demand equations also indicate an excess supply of money in relation to the level of economic activity, measured by the growth of the national product or available resources.

⁸ Because of the 16 percent interest paid on liquidity surpluses in 1972, it was not to be expected that an increase in the economy's liquidity would lead to the lowering of bank rates, but rather that it would result primarily in the growth of such surpluses. For the 16 percent actually constituted the "floor rate", propping up the bank rates even in the face of an excess supply of credit.

volume of such transactions and in the derived demand for liquidity, it is difficult to establish if these developments were the main cause of the brisker demand for liquid assets. Nevertheless, there are a number of signs tending to reinforce these assumptions.

The increase in the velocity of demand deposits strengthens the assumption that the measured decline in the circulation velocity of the money supply is downward biased, since it does not reflect transactions in existing assets. Table XIII-3 shows that the rise in the velocity of demand deposits in 1969-71 was accompanied by a rise in the velocity of the money supply relative to total uses.⁹

In 1972 these two indicators pointed in different directions: the first, reflecting the total volume of transactions in the economy, continued upward, while the second, which excludes transactions in existing assets, turned downward.

The rise in the circulation velocity of the money supply in 1969-71 mirrored the rise in interest rates during this period, which brought up the weight of time deposits and the Government Short-Term Loan in the public's liquid assets portfolio. The higher velocity of demand deposits in 1972 cannot, however, be linked to a change in interest rates (which were stable throughout most of the year), but must be ascribed to the increased share of securities in total transactions in the economy—assuming that the turnover of securities transactions is much higher than that of transactions in newly produced goods and services.¹⁰

Further corroboration is provided by the composition of the monetary expansion in 1972. The increase in the annual average balance of the money supply in 1972 was faster than that in the sum total of the money supply and interest-bearing unlinked assets: whereas the former moved up from 22.4 percent in 1971 to 30.1 percent, the growth of the money supply plus the Short-Term Loan and time deposits only accelerated from 26.8 to 28.4 percent.

Assuming that a sizable proportion of the interest-bearing unlinked assets was held as part of the public's liquid assets portfolio (see section 5b below), the swelling of the money supply in 1972 may be regarded as reflecting a certain reshuffling of this portfolio due to the aforementioned change in the economy's transactions mix. The year reviewed was the first since the end of the recession in which the annual average level of the money supply outpaced the rise in time

⁹ The velocity was calculated in relation to uses, excluding imports of ships and aircraft and direct defense imports; this is an indicator of economic activity requiring the holding of liquidity by the public.

¹⁰ This discussion assumes that there was no striking change in the velocity of currency in circulation, so that the difference between the velocity of the total money supply and that of demand deposits reflects the change in the composition of the economy's transactions, the basis of our calculations.

deposits and the Short-Term Loan,¹¹ and this despite the fractionally higher rate of interest paid on time deposits in 1972. The appreciable expansion of transactions in existing assets probably boosted demand for liquid assets in general and for money in particular. This is because transactions in securities and real estate require the holding of highly liquid assets, notably money, whereas for transactions in other markets the portfolio can consist of a higher proportion of less liquid assets—time deposits and the Short-Term Loan.

From the foregoing it is obvious that much of the liquidity and demand in 1972 shifted to financial and existing real assets. This would explain the relatively small rise in resource prices and in the import surplus, despite the abundance of liquidity prevailing in the money and capital markets this year. However, it is difficult to ascertain whether the demand pressure accompanying the rapid monetary expansion found full expression in 1972. In examining this, three aspects must be analyzed.

The first relates to the question of whether the gap between the demand and supply of liquidity can be entirely attributed to the larger volume of transactions in existing assets.¹² The second is connected with the extent to which the securities and real estate markets tied down liquidity, for a change of trend in these two speculative markets can induce the diversion of part of the liquidity to the goods and services markets, generating upward pressure on resource prices and widening the import surplus. The third aspect is connected with the continued high propensity to save, particularly in the form of financial assets.

The rapid monetary expansion, which began in the first half of 1971, slackened in the middle of 1972. This is indicated by the slower growth of the money base and the money supply (in both cases after adjusting for seasonality) in the second half of 1972 and the first quarter of 1973. However, it was not to be expected that the slackening of monetary expansion since mid-1972 would be reflected in price and balance of payments developments in the year under review. For the ample liquidity available since the middle of 1970 has apparently continued to influence developments even after the deceleration of monetary expansion.

3. MONETARY POLICY AND THE LIQUIDITY OF BANKING INSTITUTIONS

(a) *Developments during 1972*

The swelling of the Bank of Israel's net foreign currency assets decisively affected monetary developments in 1972. The absorption policy of the Treasury

¹¹ The decline in the relative share of the money supply until 1972 was apparently connected, as already mentioned, with the rise in interest rates in 1968-71.

¹² The heavy oversubscription of the Bank Leumi le-Israel convertible bond issue in November 1972 and that of the Israel Discount Bank in January 1973 suggests that they were largely financed not through overdrafts but from the public's demand deposit holdings.

and the Bank of Israel counteracted part of the expansionary impact of foreign currency accumulation, but only in the second half of 1972 did the liquidity infusion begin to taper off.

As may be seen from Table XIII-4, net foreign currency accumulation at the Bank of Israel reached \$ 569 million (or IL 2,390 million) in 1972. Nearly all the increment accrued from the nongovernmental sector, since the Government's foreign currency purchases for executing payments abroad exceeded the Jewish Agency's foreign currency transfer receipts by some IL 185 million. Moreover, the nongovernmental sector sold \$ 70 million to the Bank of Israel, which in turn lent it to the Jewish Agency for the repayment of foreign debts.

The nongovernmental sector's surplus of foreign currency receipts, which amounted to an appreciable IL 1,600 million in 1971, rose by a further IL 1,000 million in 1972.¹³

The definition of the nongovernmental sector in this chapter is not very precise, since a sizable proportion of the capital import is by entities largely under Government control, such as financial institutions, public sector companies, and, to a certain extent, nonprofit institutions.

The reasons for the huge surplus of foreign currency receipts in the nongovernmental sector were discussed at length in Chapter III, "The Balance of Payments". The developments in 1972 may be viewed as the continuation of a trend that began in 1970 and gained momentum after the devaluation of August 1971, and was reflected by the stabilization of the current deficit and an enormous inflow of private transfers from abroad—foreign investment capital, transfers by Israeli residents, immigrant transfers, and personal restitution receipts. It is noteworthy that the biggest increases were in items not under Government control, while those controlled by the Government continued upward.

The expansionary influence of the incremental foreign currency transfers (in dollar terms) was magnified in 1972 by the higher rate at which they could be converted after the devaluation of the Israeli pound in August 1971. However, the public did not display any greater readiness in 1972 to convert restitution receipts or part of their Pazak and Tamam balances. As will be explained in section 5 below, the additional liquidity infused by restitution receipts stemmed primarily from the greatly expanded volume of such funds transferred to Israel, and only to a very minor extent from the rise in the conversion rate.

During the first months of 1972 foreign currency accumulation reached sizable proportions, but there was a noticeable slackening in the second half of the year. Sales of foreign currency to the Bank of Israel by the nongovernmental

¹³ The use of a different definition of Government absorption, which treats food imports as a nongovernmental sector transaction and hence excludes it, would reduce the nongovernmental sector's surplus foreign currency receipts by IL 720 million in 1972 and IL 636 million in 1971 (see the explanation in section 6b below).

Table XIII-4

I. EXTERNAL INFUSIONS, BY COMPONENT, 1970-72

(IL million)

End of period	Net foreign currency assets at the Bank of Israel	Bank of Israel credit			Total external infusions
		To the Govt. ^a	To the Jewish Agency	To the public	
1970	1,225.5	3,693.2	124.9	738.0	5,781.6
1971	2,299.1	5,112.9	125.0	879.6	8,416.6
1972	4,688.7	4,564.6	415.1	858.5	10,526.9
1972 January	2,368.3	5,206.7	121.3	906.8	8,603.1
February	2,805.9	5,097.8	119.8	919.1	8,942.6
March	3,421.4	4,568.8	118.8	911.5	9,020.5
April	3,738.8	4,676.0	115.0	941.1	9,470.9
May	3,938.3	4,730.2	159.8	936.5	9,764.8
June	4,045.8	4,806.1	158.7	957.7	9,968.3
July	4,197.7	4,819.4	184.4	987.4	10,188.9
August	4,229.2	4,778.1	287.9	916.7	10,211.9
September	4,243.2	4,769.7	421.3	899.5	10,333.7
October	4,389.3	4,701.6	417.6	829.7	10,338.2
November	4,479.9	4,689.2	416.1	855.8	10,441.0
December	4,688.7	4,564.6	415.1	858.5	10,525.9

^a Excluding capital and sundry accounts and nonliquid bank deposits with the Bank of Israel.

Table XIII-4 (contd.)

II. ASSETS CREATED BY EXTERNAL INFUSIONS, 1970-72

(IL million)

End of period	Short-Term Loan held by the public	Currency in circulation	Net foreign currency balances of banking institutions with Bank of Israel	Balances in transit and other accounts	Liquid assets ^b of banking institutions	Total assets created by external infusions
1970	559.1	1,280.7	2,789.9	51.0	1,100.9	5,781.6
1971	714.2	1,584.4	4,169.3	-6.7	1,955.4	8,416.6
1972	745.2	1,973.8	4,754.7	22.8	3,030.4	10,526.9
1972 January	745.4	1,608.0	4,229.9	34.3	1,985.5	8,603.1
February	761.1	1,655.9	4,348.2	58.5	2,118.9	8,942.6
March	758.1	1,765.6	4,465.9	-20.0	2,050.9	9,020.5
April	767.5	1,761.6	4,524.9	42.0	2,374.9	9,470.9
May	771.9	1,782.8	4,555.4	26.1	2,628.6	9,764.8
June	788.2	1,829.4	4,606.8	1.4	2,742.5	9,968.3
July	811.8	1,867.5	4,626.6	66.1	2,816.9	10,188.9
August	804.0	1,889.5	4,626.0	69.9	2,822.5	10,211.9
September	802.0	1,934.2	4,666.1	48.6	2,882.8	10,333.7
October	811.9	1,948.3	4,684.3	79.2	2,814.5	10,338.2
November	785.9	1,967.1	4,708.5	28.8	2,950.7	10,441.0
December	745.2	1,973.8	4,754.7	22.8	3,030.4	10,526.9

^b Excludes nonliquid bank deposits and exemptions from the liquidity requirements.

sector totalled an estimated IL 1,800 million in the first half of 1972 and IL 900 million in the second half.¹⁴

The more sluggish accumulation in the second half of 1972 was apparently due to two factors: (a) the usual seasonal decline during this period; and (b) the sagging of the uptrend in foreign currency transfers to Israel, which became more pronounced after the August 1971 devaluation. There are no seasonally adjusted data permitting the isolation of the influence of these two factors, but data for the first quarter of 1973 show a slower foreign currency accumulation compared with the corresponding period in the previous year, thus supporting the assumption about a change of trend in mid-1972.

In the first half of 1972 accumulation was on so great a scale that, despite the energetic effort of the Treasury and the Bank of Israel to mop up liquidity, the money base expanded by IL 896 million, or 21.5 percent, between the end of December 1971 and the end of June 1972. This is an average monthly rise of 3.6 percent, or 3.2 percent after adjusting for seasonality (see Table XIII-5).

Since most of the absorption by the Bank of Israel in the first half of 1972 was due to the scaling up of liquidity ratios (discussed below), whereas in the second half the reduction of its rediscounting operations was the main factor, the Bank's absorption was reflected not in the diminution of the money base, but in a decrease in the money supply multiplier. Despite the large amount of liquidity pumped out of the economy by the Bank, monetary expansion was still very rapid in the first half of 1972: the money supply went up by 16.9 percent, or 14 percent after adjusting for seasonality.

The liquidity situation during this period found expression in the substantial surpluses held by the banking institutions in the first half of 1972, except for the usual deficit in March associated with the end of the fiscal year (see Table XIII-6). Foreign currency accumulation during the first six months of 1972 was so great as to permit a very rapid monetary expansion despite several countervailing factors: the scaling up of liquidity ratios, a steep seasonal dip after the termination of the citrus season in the volume of credit granted within the framework of the liquidity exemptions, and a net absorption of funds by the Accountant General in the first part of the 1972/73 fiscal year, in contrast to the usual development at the beginning of a new fiscal year.

The constrictive effect of these three factors, though considerable, was insufficient to offset the liquidity infusion, so that the first half of 1972 was characterized by an abundance of liquidity.

In the second half of the year, as already noted, foreign currency accumulation slackened, and the combined outcome of this development and the absorptive measures of the Government and the Bank of Israel was a significant abating

¹⁴ Sales by the nongovernmental sector are defined here as foreign currency sold to the Bank of Israel by all sectors of the economy other than the Government and the Jewish Agency. They do not include the foreign currency income of the Bank of Israel.

Table XIII-5

THE MONEY BASE, BY COMPONENT, 1970-72

(IL million)

End of period	Currency in circulation	Liquid assets of banking institutions	Money base, narrowly defined (1 + 2)	Liquidity exemptions	Authorized liquidity deficit due to change in structure of directed credit funds	Money base, broadly defined		
						Original data (3 + 4 + 5)	Seasonally adjusted	Percent monthly increase, seasonally adjusted
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1970	1,280.7	1,100.9	2,381.6	534.8	—	2,916.4		
1971	1,584.4	1,955.4	3,539.8	635.3	—	4,175.1		
1972	1,973.8	3,030.4	5,004.2	474.0	4.2	5,484.2		
1972 January	1,608.0	1,985.2	3,593.2	646.6	—	4,239.8	4,336.5	3.1
February	1,655.9	2,118.9	3,774.8	619.2	—	4,394.0	4,458.0	2.8
March	1,765.6	2,050.9	3,816.5	628.9	—	4,445.4	4,602.6	3.3
April	1,761.6	2,374.9	4,136.5	576.2	—	4,712.7	4,752.8	3.2
May	1,782.8	2,628.6	4,411.4	530.2	—	4,941.6	4,900.0	3.2
June	1,829.4	2,742.5	4,571.9	403.8	95.6	5,071.3	4,983.5	1.6
July	1,867.5	2,816.9	4,684.4	411.1	45.8	5,141.3	5,002.7	0.4
August	1,889.5	2,822.5	4,712.0	421.3	74.1	5,207.4	5,105.3	2.1
September	1,934.2	2,882.8	4,817.0	436.4	49.5	5,302.9	5,202.0	1.9
October	1,948.3	2,814.5	4,762.8	456.1	93.7	5,312.6	5,325.7	2.3
November	1,967.1	2,950.7	4,917.8	461.7	44.4	5,423.9	5,450.0	2.3
December	1,973.8	3,030.4	5,004.2	474.0	4.2	5,482.4	5,521.0	1.4

of the infusion. This was reflected by a somewhat slower expansion of the money supply, the disappearance of the banking institutions' liquidity surpluses, and even a move to a deficit position toward the end of the year. The more sluggish accumulation was partly due to seasonal factors, but their influence was partly offset by two expansionary developments: a seasonal increase in directed credit to citrus growers, and the tumbling of Short-Term Loan sales, which in November and December actually resulted in a IL 67 million infusion due to the shrinkage of the public's holdings of this paper.

Table XIII-6

INDICATORS OF THE LIQUIDITY POSITION OF BANKING INSTITUTIONS, 1970-72
(percentages)

End of period	Actual liquidity ratio on ordinary deposits	Liquidity exemptions ^a	Formal liquidity ratio on ordinary deposits (1+2)	Required liquidity ratio on ordinary deposits	Free reserves (IL million; surplus-, deficit+)		Free reserves as a percent of liquid assets (daily average)
					End of month	Daily average during month	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	38.2	25.2	63.4	65.5	-35.1	8.2	0.8
1971	48.2	22.7	70.9	67.5	105.6	131.2	7.0
1972	57.4	13.0	70.4	72.0	-47.5	-32.8	-1.1
1972 January	47.6	23.0	70.6	67.5	67.0	96.2	4.9
February	49.7	21.6	71.3	69.5	62.6	71.5	3.4
March	43.7	20.9	64.6	70.0	-150.2	28.9	1.3
April	52.8	18.8	71.6	71.0	29.4	-89.2	-4.0
May	58.7	16.7	75.4	72.0	117.9	63.1	2.5
June	59.7	13.8	73.5	72.0	59.1	80.8	3.1
July	60.5	13.7	74.2	72.0	82.7	44.2	1.6
August	60.0	14.9	74.9	72.0	106.5	44.0	1.6
September	59.7	14.2	73.9	72.0	73.8	105.4	3.6
October	56.1	16.0	72.1	72.0	13.3	63.6	2.2
November	54.8	13.5	68.3	72.0	-128.1	4.5	0.2
December	57.4	13.0	70.4	72.0	-47.5	-32.8	-1.1

^a Including authorized liquidity deficits.

The slowdown in the growth of the money base, which began in mid-1972 and continued through the first quarter of 1973 (even according to de-seasonalized data) had two major repercussions: first, the expansion of the money supply weakened somewhat between June and September 1972, and in the first quarter of 1973 there was no growth at all; and secondly, demand for nondirected bank credit grew stronger, heavily depleting the banks' free re-

serves in the final quarter of 1972 and even more in the first three months of 1973. These developments reflect the fact that, while the liquidity infusions subsided in the second half of 1972, demand for liquidity for financing the growing volume of transactions in various markets continued to mount. When this demand could not be met from the external infusions, it began to press on an alternative source of supply—bank credit. The brisker demand for such financing was apparently also connected with the steps taken to brake the external infusions, such as the deferring and delaying of payments by the Accountant General in order to help create a budgetary surplus, and the restrictions imposed on foreign currency borrowing. Another contributory factor was the increased demand for bank credit by owners of time deposits anxious to avoid breaking their deposits before the terminal date.

When demand for such credit began to mount, the institutions possessed substantial liquidity surpluses, which were further augmented by the mobilization of additional equity capital. These sources enabled the institutions to meet the demand for credit, thus largely neutralizing the restrictive impact of the more laggard external infusions on such demand. The liquidity surpluses gradually evaporated, and in December 1972 the banking institutions began to incur liquidity deficiencies, a development that continued until the end of March 1973. Some idea of the influence of the growth of nondirected credit to the public since September 1972 may be gained from the following data: between the end of July and the end of December 1972 the money base grew by 6.6 percent, while the money supply expanded by 8.3 percent. At the end of March 1973 the money base was at its level at the end of July 1972, while the money supply went up 9.2 percent during this period.

The expansion of bank credit in the second half of 1972 was, as noted, one of the factors blunting the contractionary influence of the reduced liquidity infusion on demand in the various sectors of the economy. In other words, despite the smaller liquidity infusion, the development of the monetary aggregates failed to offset the inflationary effect of the excess demand prevailing in the economy in the year reviewed.

Another factor contributing to the lagged effect of the weaker liquidity infusion was the relative stability of nominal bank rates in the second half of 1972. This stability was connected, on the one hand, with the absorptive measures pursued by the Bank of Israel and, on the other hand, with the response of the banking institutions to the stronger demand for nondirected credit.

The Bank of Israel's policy for 1972 was aimed at limiting the banking institutions' capacity for expanding their credit business rather than raising interest rates directly. Thus, for example, the Bank refrained from upping the yield on the Short-Term Loan in the second half of 1972, a step which would have prevented the liquidity injection due to the contraction of the public's holdings of this paper in the last quarter of the year. It is reasonable to assume that

the raising of the yield at a time when the money market was becoming tighter would, in the final analysis, have forced the banking institutions to raise their interest rates. On the other hand, the banks refrained from hiking their rates despite the excess demand for credit in the second half of the year. This was due partly to public pressure and partly to the belief that the liquidity shortage would be short-lived.

Various signs indicate that during the second half of 1972, and especially toward the end of the year, the expectation of a sharpening of the inflation grew stronger. In such a situation the stability of nominal interest rates in itself probably contributed to the heavier demand for credit, as borrowers anticipated a decline in real interest rates—a development which, as already mentioned, blunted the restrictive influence of the shrinkage of liquidity in the economy.

(b) *Monetary policy*

The direct budgetary operations of the Government and the Jewish Agency, along with the Bank of Israel's monetary policy, resulted in a large-scale liquidity absorption in 1972. These measures were intended to check the growth of the money supply, after a 28.2 percent jump in 1971. The stimulative effect of the devaluation on the nongovernmental sector's foreign currency receipts stymied the realization of this aim in the first half of the year, but there was a positive turn in the second half, which grew more pronounced in the first quarter of 1973.

Government and Jewish Agency operations in 1972 were designed to mop up more liquidity than in the previous year, and were implemented at a fairly even pace in both halves of the year (see section 6b below).

The Bank of Israel siphoned off liquidity throughout most of the year, using a variety of methods:

1. It scaled up the liquidity ratio on time deposits by one percentage point on January 13, February 10, and March 9, completing the series of revisions begun in the middle of December 1971, when the ratio was raised by two points. This measure reduced the banking institutions' liquidity by an estimated IL 81 million in 1972 (calculated according to the deposit balances on the dates the ratio was changed).

2. During the months of February–May 1972 the liquidity ratio on demand deposits was raised by a total of 4.5 points—on February 3 and 24, April 13, and May 11 by one point each and on March 23 by half a point. These changes absorbed an estimated IL 131 million (calculated according to the deposit balances on the dates the ratio was changed).

3. On June 29 the structure of the working capital credit funds was revised, with the banks' participation from their free resources ("heavy money") being increased and the share of liquidity exemptions and Bank of Israel rediscounts reduced. At the same time, the rate of interest charged borrowers was raised by 2 percentage points. The sum mopped up by these changes during the period June–August 1972 is estimated at IL 164 million.

4. In August and September 1972, IL 94 million was drained off by a change in the structure of the Export Production Fund. This brought up the share of "heavy money" in the fund from 25 to 45 percent.

5. In the last three months of 1972, IL 139 million was absorbed by the increase in the proportion of "heavy money" in the Fund for Financing Export Shipments. The banks' participation was raised from 40 to 65 percent and the share of rediscounts reduced.¹⁵

6. With the disappearance of liquidity surpluses in November, the Bank of Israel stopped paying the banks 16 percent interest on the surpluses deposited with it. This rate had been fixed after the devaluation of August 1971 as a means of discouraging banking institutions from expanding credit to the public. Given the relatively abundant liquidity prevailing until October 1972, this rate influenced the institutions' readiness to hold liquidity surpluses. But when demand for credit grew stronger in the last quarter of 1972, the 16 percent rate was no longer a sufficient incentive.

7. Bank of Israel operations in the open market only absorbed IL 31 million in 1972. This did not proceed at an even pace: until July some IL 98 million was mopped up, but between the end of July and the end of October Short-Term Loan holdings of the public remained stationary, and in November and December they contracted sharply.

8. At the end of 1972 the Bank of Israel announced several additional absorptive measures, which went into force in the first quarter of 1973. These included the hiking of the liquidity ratio on time deposits by 2 points and the obligating of the banks to deposit with the Bank of Israel an amount equal to 65 percent of the total balance in the Imports-for-Exports Fund. These measures accounted for approximately IL 125 million during the first quarter of 1973.

In addition, the Bank of Israel made an arrangement with the banking institutions whereby they were to underwrite Short-Term Loan issues as of the middle of January 1973, and they committed themselves to increase the outstanding balance of this paper during 1973 by some IL 140 million above its level on the date of the agreement.

These measures highlight the Bank of Israel's intention to reduce the banking institutions' capacity to expand its nondirected credit operations and to head off an excessive growth of directed credit, without generating direct pressure on interest rates by raising the yield on the Short-Term Loan or by paying the banking institutions a higher rate of interest on their liquidity surpluses. The

¹⁵ This structural change was accompanied by the creation of a new fund for financing export shipments, to which credits not repaid within 190 days (with the Bank of Israel's authorization) were transferred. The new fund charges interest of 9 percent, compared with 6 percent in the regular fund, and the banks' participation in the form of "heavy money" comes to 75 percent. At the end of 1972 the balance of the new fund stood at about IL 10 million.

energetic application of these measures, designed to influence the quantity of credit rather than its price, reflected both the public's strong opposition to the upping of interest rates and the difficulty of explaining the anti-inflationary effect of an interest rate hike. However, market forces can normally be expected to drive up interest rates relatively quickly if the supply of credit is effectively restricted. This is because of the stiff penalties imposed by the Bank of Israel on institutions incurring a liquidity deficiency by expanding credit more than their liquid asset growth permits.

Altogether, the Bank of Israel's operations absorbed IL 640 million in 1972, based on the balance of the relevant magnitudes on the dates when the various measures listed above were implemented. However, this figure does not reflect their full impact, which was felt in two areas: The first was the contraction of the money base as a result of the changes in the structure of the aforementioned credit funds and the Bank of Israel's open-market operations. The former kept rediscounts and liquidity exemptions down by an estimated IL 427 million and, together with the open-market operations, prevented the expansion of the money base by IL 458 million. The Bank's absorptive measures also left their impress on the money supply multiplier. The raising of the liquidity ratio on time deposits by 3 percentage points and that on demand deposits by 4.5 points reduced the money supply multiplier by 0.053 of a point.¹⁶

The combined effect of the slower expansion of the money base and the reduction of the money supply multiplier was a IL 780 million decrease in the potential growth of the money supply. In other words, if not for these measures the latter would have increased by 14 percent more than the 29 percent actually recorded. It is important to note here that this estimate of the total effect of the absorptive operations on the growth of the money supply is based on the assumption that the composition of the monetary expansion and changes in free reserves are not dependent upon the scale of absorption.

So far the discussion has dealt with the Bank of Israel's absorptive measures, without taking into account the liquidity infusion engendered through its supply of directed subsidized credit.

Under the existing institutional arrangements for financing exports and working capital requirements in high-priority branches, the Bank of Israel, in executing rediscounts and providing credit within the framework of the liquidity exemptions, injects liquidity into the economy, with the infusion increasing almost automatically with the expansion of exports. This institutional setup explains the difference between the actual decline in rediscounts and liquidity exemptions in 1972 and that attributable to the above structural changes in the credit funds. In the year reviewed Bank of Israel rediscounts were cut by IL 21 million and liquidity exemptions by IL 161 million. This was only half the total

¹⁶ Given the size of the money base at the end of 1972, a decrease in the multiplier from 1.086 to 1.033 would in itself prevent the growth of the money supply by some IL 240 million.

decrease in the money base due to the aforementioned structural changes; the difference between the decrease in the money base attributable to this factor and the actual decline in rediscounts and liquidity exemptions stemmed from the expansion of Bank of Israel directed credit from IL 2,144 million at the end of 1971 to IL 2,487 million at the end of 1972. The latter development forced the Bank to increase its rediscounts and liquidity exemptions, thus counteracting part of the restrictive effect of the change in the funds' structure.

Despite the IL 343 million growth of directed credit, the altering of the funds' structure enabled the Bank of Israel to reduce its rediscounts and liquidity exemptions by IL 182 million.

4. THE MONEY SUPPLY

The money supply grew by IL 1,246 million, or 28.7 percent, in 1972. This was virtually the same rate as in 1971—28.2 percent;¹⁷ but despite the similarity in these annual rates, the within-year growth pattern differed. In 1971 the money supply (seasonally adjusted) expanded by 14.5 percent in the second half of the year, compared with 11.7 percent in the first half,¹⁸ while in 1972 it was the other way around—the level moved up 12.8 percent in the second half of the year, as against 14 percent in the first half (see Table XIII-7). As already noted, these developments were connected with the accelerated growth of the money supply after the devaluation of August 1971 and with the subsequent slowdown due to the slacker accumulation of foreign currency in the second half of 1972.

Though the money supply (seasonally adjusted) rose strongly in the last quarter of both years, the basic causes differed: whereas in 1971 the upward thrust came from the enormous liquidity infusion following the devaluation of the Israeli pound, in 1972 the fourth-quarter liquidity infusion was relatively small, but credit to the public was stepped up appreciably to meet the greater demand. This difference is reflected in the banks' free reserves: whereas in 1971 they expanded appreciably in the last quarter of the year, in 1972 they were heavily depleted.

The declining trend in the ratio between currency in circulation and demand deposits, evident since the second half of 1970, carried over through 1972, when the average monthly balance of currency came to 36.4 percent of the money supply, compared with 37.7 percent in 1971 and 38.8 percent in 1970. Ac-

¹⁷ The rapid growth of the money supply in the second half of 1971 and the first half of 1972 necessitated the submission of two reports during the year reviewed by the Governor of the Bank of Israel, in accordance with section 35 of the Bank of Israel Law. The first, submitted in the middle of April, covered the period between the end of June 1971 and the end of February 1972, while the second, submitted at the end of August, covered the period between the end of February and the end of July 1972.

¹⁸ According to revised seasonally adjusted data for 1971.

Table XIII-7
 THE MONEY SUPPLY, MONTHLY, 1972
 (IL million)

End of period	Currency ^a			Demand deposits ^b			Money supply			Money supply, seasonally adjusted		
	Total	Monthly increase		Percent of money supply	Total	Monthly increase		Total	Monthly increase		Total	Percent monthly increase
		IL m.	%			IL m.	%		IL m.	%		
1971 December	1,584.4	9.9	0.6	36.5	2,756.9	150.1	5.8	4,341.3	160.0	3.8	4,379.6	3.0
1972 January	1,608.0	23.6	1.5	36.6	2,785.2	28.3	1.0	4,393.2	51.9	1.2	4,501.4	2.8
February	1,655.9	47.9	3.0	36.9	2,827.5	42.3	1.5	4,483.4	90.2	2.1	4,566.2	1.4
March	1,765.6	109.7	6.6	37.2	2,984.8	157.3	5.6	4,750.4	267.0	6.0	4,719.1	3.3
April	1,761.6	-4.0	-0.2	36.6	3,048.1	63.3	2.1	4,809.7	59.3	1.2	4,774.4	1.2
May	1,782.8	21.2	1.2	36.3	3,132.4	84.3	2.8	4,915.2	105.5	2.2	4,896.4	2.6
June	1,829.4	46.6	2.6	36.0	3,246.0	113.6	3.6	5,075.4	160.2	3.3	4,993.8	2.0
July	1,867.5	38.1	2.1	36.2	3,290.5	44.5	1.4	5,158.0	82.6	1.6	5,083.1	1.8
August	1,889.5	22.0	1.2	36.4	3,300.8	10.3	0.3	5,190.3	32.3	0.6	5,181.5	1.9
September	1,934.2	44.7	2.4	36.4	3,384.8	84.0	2.5	5,319.0	128.7	2.5	5,240.2	1.1
October	1,948.2	14.0	0.7	36.2	3,435.2	50.4	1.5	5,383.4	64.4	1.2	5,385.6	2.8
November ^c	1,967.1	18.9	1.0	36.3	3,453.4	18.2	0.5	5,420.5	37.1	0.7	5,507.6	2.3
December	1,973.8	6.7	0.3	35.3	3,613.4	160.0	4.6	5,587.2	166.7	3.1	5,631.5	2.3

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

^b Including demand deposits in the Israel Bank of Agriculture and in branches of Israeli banks operating in the administered areas.

^c Adjusted for the influence of the subscription to Bank Leumi security issues on demand deposits on the last day of November.

ording to a Bank of Israel study, the decline is connected with the lagged adjustment of the money supply components to large external infusions.¹⁹ A much heavier infusion initially depresses the proportion of currency, but after several months the ratio picks up and proceeds to move in line with the long-run trend.

5. OTHER LIQUID ASSETS OF THE PUBLIC

The uptrend in other liquid assets held by the public—time deposits in Israeli and foreign currency, the Short-Term Loan, and approved saving schemes—sagged from 34.7 percent in 1971 (25.1 percent excluding devaluation increments) to 19.5 percent (IL 1,800 million) in the year reviewed.

All three component items contributed to the slowdown. Since the underlying factors differed in each case, they will be examined separately (see Table XIII-8).

(a) *Pazak and Tamam accounts*

The expansion of Pazak and Tamam deposits slowed noticeably in 1972—from 48.3 percent the year before to 15.2 percent. The impressive 1971 increase reflected the appreciation of the IL value of the balances due to the alteration of the exchange rate of the Israeli pound in relation to the German mark, while their expansion in 1972 reflected the appreciable demand for assets linked to the mark.

Section 3 above described the influence on the economy's liquidity of the conversion of personal restitution receipts, Pazak deposits of restitution recipients, and Tamam balances. Here we shall discuss the changes in the behavioral pattern of restitution recipients and in their propensity to convert their current receipts and Pazak and Tamam balances. The increase in Pazak restitution and Tamam deposits in 1972 totalled IL 465 million, while nonrestitution Pazak balances grew by IL 140 million. Conversions of these two types of Pazak accounts will be analyzed separately below.

Personal restitution from West Germany totalled IL 1,105 million in 1972. The interest received by holders of Pazak restitution and Tamam deposits amounted to IL 181 million, while the revaluation of the mark appreciated the balances by a further IL 82 million (see Table XIII-9). The total potential increase in these accounts in 1972 therefore came to IL 1,368 million, while the actual increase was IL 465 million; the difference of IL 902 million (66 percent of the total) represents conversions. This far eclipsed the 34 percent rate posted in 1971.

¹⁹ See A. Marom, "The Relationship between the Money Supply and the Money Base", Bank of Israel, *Economic Review*, No. 39, August 1972.

Table XIII-8

OTHER LIQUID ASSETS HELD BY THE PUBLIC, 1970-72^a

(IL million)

End of period	Time deposits in Israeli currency	Approved saving schemes	Deposits against liabilities	Deposits linked to the exchange rate (Pazak)	Foreign currency deposits (Tamam)	Other foreign currency deposits	Total less-liquid deposits (1 to 6 incl.)	Short-Term Loan	Grand total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1970	2,141.1 ^b	1,245.4	16.2	1,959.3	370.8	196.1	5,388.9	559.1	5,948.0
1971	2,859.1	1,482.6	16.1	2,823.9	1,166.3	159.5	8,507.5	714.2	9,221.7
1972	3,745.8	1,751.5	28.9	3,204.4	1,391.3	154.5	10,276.4	745.2	11,021.6
1972 January	2,855.1	1,500.1	18.8	2,880.9	1,191.8	169.4	8,616.1	745.4	9,361.5
February	2,958.0	1,516.2	16.7	2,954.2	1,219.8	160.3	8,825.2	761.1	9,586.3
March	2,995.2	1,534.7	17.1	3,031.5	1,251.0	182.9	9,012.4	758.1	9,770.5
April	3,057.4	1,555.0	16.9	3,056.1	1,274.4	198.2	9,158.1	767.5	9,925.6
May	3,145.1	1,578.2	19.0	3,068.2	1,293.2	189.5	9,293.2	771.9	10,065.1
June	3,227.2	1,603.8	17.2	3,108.9	1,314.8	213.5	9,485.4	788.2	10,273.6
July	3,300.6	1,624.8	18.9	3,147.4	1,322.6	168.5	9,582.8	811.8	10,394.7
August	3,399.4	1,646.0	16.5	3,166.2	1,325.2	167.0	9,720.3	804.0	10,524.3
September	3,439.7	1,663.4	20.7	3,190.5	1,341.5	174.7	9,830.5	802.0	10,632.5
October	3,600.6	1,690.5	26.9	3,182.8	1,358.2	148.9	10,007.9	811.9	10,819.8
November	3,669.1	1,717.6	30.3	3,198.8	1,369.0	154.3	10,139.1	785.9	10,925.0
December	3,745.8	1,751.5	28.9	3,204.4	1,391.3	154.5	10,276.4	745.2	11,021.6

^a Excluding deposits of the public earmarked for loans, most of which belong to social insurance funds and financial institutions.^b Data for the end of 1970 include IL 21.4 million in bill brokerage.

The low rate of conversions in 1971 is largely explained by the high proportion of DM revaluation and IL devaluation differentials in the total potential growth of Pazak and Tamam accounts and the low propensity to convert such receipts. But even after isolating this factor (by assuming that none of the devaluation or revaluation increments were converted), it turns out that 70 percent of the restitution receipts and interest on Pazak and Tamam accounts were converted in 1972, compared with 62 percent the year before.

The higher rate of conversions in 1972 was connected with several factors: first was the sharpening of the inflation in Israel and the accompanying shift in investors' preferences from non-index-linked financial assets to real assets and perhaps also to shares and index-linked bonds. The second factor was the slight drop in the exchange rate of the German mark in May-December 1972, following a precipitate rise in 1971 and the first four months of 1972. This, together with the absence of IL devaluation expectations, prompted the public to reshuffle its assets portfolio, thereby leading to an increased conversion of Pazak and Tamam funds. The third factor was the enormously larger volume of restitution transferred to Israel in 1972. According to various indicators, these transfers included sums received in previous years but which, because of the two factors described above, were brought to Israel only in 1972. Such transfers are by their very nature intended for conversion, the desire to use marks for buying financial or other assets in Israel being the main motive for bringing the funds to this country.²⁰

The rate of conversions in 1972 was fairly high compared with the years 1965-71, though an exact comparison is difficult owing to the absence of data on nonrestitution Pazak deposits before 1971.²¹ It is reasonable to assume that the strong inflation prevailing in Israel, the belief that the Israeli pound would not be devalued in the near future in relation to either the dollar or the mark, and the lagged effect of the growth of Pazak and Tamam deposits after the devaluation of August 1971 combined to account for the relatively high proportion of conversions in 1972.

Despite the higher rate of conversions in 1972, demand for DM-linked assets continued to be strong. This is indicated by the further appreciable growth of Pazak and Tamam deposits, after the 48.3 percent advance posted in 1971. The increased conversion of such funds thus reflected a certain adjustment of the public's asset portfolio, but the relatively modest size of the increment

²⁰ The fact that interest rates on Pazak and Tamam deposits held steady in 1972 while those on Euromark deposits declined may help to explain the enormous increase in transfers of personal restitution funds. It is difficult to quantify the contribution of this factor or the uses made of the transferred funds.

²¹ Before 1971 the entire annual increase in Pazak and Tamam was attributed to personal restitution receipts. Adjusting for the growth of nonrestitution Pazak balances, on the assumption that these deposits did in fact increase, would bring up the calculated rate of conversions of personal restitution receipts.

Table XIII-9
ESTIMATED CONVERSION OF PAZAK AND TAMAM FUNDS BY RESTITUTION RECIPIENTS, 1971-72^a
 (IL million)

	Resti- tution receipts	Interest on Pazak and Tamam accounts	Devaluation differentials on Pazak and Tamam accounts	Total potential increase in Pazak and Tamam accounts (1+2+3)	Less: Actual increase	Amount converted into IL (4-5)	Rate of conversion	
							A (6 ÷ 4)	B ^b (6 ÷ [1+2])
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1971	853.5	129.0	782.7	1,765.2	1,159.8	605.4	34	62
1972	1,104.5	181.0	82.0	1,367.5	465.2	902.3	66	70
1972 January	65.2	15.9	50.9	132.0	85.9	46.1	35	57
February	91.8	18.5	30.9	141.2	85.0	56.2	40	51
March	124.2	15.4	13.2	152.8	86.4	66.4	43	48
April	100.6	13.1	8.1	121.8	50.8	71.0	58	62
May	141.1	16.8	-4.6	153.3	14.0	139.3	91	88
June	108.8	17.2	-4.9	121.1	35.3	85.8	71	68
July	81.0	7.0	15.3	103.3	34.2	69.1	67	79
August	74.6	12.1	-19.0	67.7	22.2	45.5	67	52
September	72.2	13.8	-6.4	79.6	11.6	68.0	85	79
October	79.2	17.5	-9.8	86.9	5.6	81.3	94	84
November	65.9	13.7	15.0	94.6	18.9	75.7	80	95
December	99.8	20.0	-6.7	113.1	15.3	97.8	86	82
Total	1,104.5	181.0	82.0	1,367.5	465.2	902.3	66	70

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

^b This calculation assumes that linkage differentials (arising from the upward revaluation of the German mark and from the devaluation of the IL) are accumulated in full; in other words, the funds converted originate solely in restitution receipts and the interest on Pazak and Tamam accounts.

clearly suggests that restitution recipients view the link to the German mark as a good way to protect the value of their savings. The slight retreat in the exchange rate of the mark apparently influenced the timing of conversions in the short run, but did not cause any flight from this currency. The devaluation of the dollar in February 1973 vindicated the behavior of the majority of holders of Pazak and Tamam accounts.

Nonrestitution Pazak deposits expanded in 1972 by \$ 33 million, or 19 percent. This substantial growth, despite the absence of devaluation expectations, was apparently connected with the sizable increase in capital imports and transfers by Israeli residents. Presumably these deposits serve as transit accounts for holding funds transferred to the country until their final disposition. Consequently, their expansion should not be regarded as contradictory to what has been said about the general lack of devaluation expectations.

(b) *Unlinked liquid assets*

The expansion of unlinked "other liquid assets of the public" slackened in 1972 while their composition changed: the weight of time deposits increased and that of the Short-Term Loan declined. The faltering of the uptrend in this asset category stands out when compared with its growth in previous years and the increase in the money supply in 1972.

Interest-bearing assets were up by IL 914 million, or 25.6 percent, in 1972, after advancing 32.4 percent in 1971 and 27 percent in 1970. In both 1970 and 1971 the growth of these assets outpaced that of the money supply, which moved up by 14 and 28.2 percent respectively. In contrast, in 1972 the money supply expanded by 28.7 percent—i.e. faster than unlinked interest-bearing assets.

The lagging of the uptrend in unlinked assets and the accelerated expansion of the money supply have been evident since the devaluation of August 1971.

The sizable growth of unlinked assets in 1970–71, despite the rapid advance of prices during this period, was discussed in the 1971 *Annual Report*.²² This development was attributed, first and foremost, to the high degree of substitutability between these assets and demand deposits as far as the deposit owners are concerned. In other words, the soaring of time deposits and Short-Term Loan holdings was connected with the fact that they are a convenient substitute for money in satisfying the public's liquidity requirements, and not with their intrinsic role as a medium- or long-term savings instrument.²³ Because of the high degree of interchangeability between money holdings and unlinked interest-bearing assets, the relative development of these two groups is influenced chiefly

²² See Bank of Israel, *Annual Report 1971*, pp. 316–17.

²³ This applies particularly to large deposits of business firms and institutions, which have a high liquidity due to the special arrangements permitting such clients to "break" their deposits, i.e. to draw on them before the terminal date.

by changes in nominal interest rates and by the composition of the economy's business transactions. Expectational changes concerning the advance of prices do not explain the shift from money holdings to time deposits, since neither protect the owner against the erosion of money.

The continued relatively rapid growth of time deposits and outstanding Short-Term Loan certificates in 1972 was associated with their liquidity-holding function in many sectors of the economy. The fact that they trailed behind the growth of the money supply is explained by a number of factors:

1. The year reviewed was the first since 1968 in which interest rates on unlinked interest-bearing assets did not rise sharply.

2. The larger volume of transactions in existing assets (see section 2 above), coupled with the need to hold highly liquid assets for this purpose, may explain the relatively faster growth of the money supply in 1972.

3. The greater anticipation of a prolonged inflation which prevailed after the devaluation of August 1971 undoubtedly encouraged the switching of funds to assets maintaining their real value. The reference is to time deposits and Short-Term Loan certificates held as a savings instrument.

4. Two other factors may partly explain the marked rise in time deposits: the data on the 1972 increase include deposits for a two-year period, which are linked to the consumer price index; and certain banks permitted their clients to obtain credit against time deposits, thus preventing the breaking of deposits and retarding their growth when liquidity became tighter in the second half of 1972.

Examination of the growth of time deposits in 1972 according to their size shows an accelerated increase in large deposits—owned mostly by businesses, institutions, and various organizations—and a slackening in the growth of small deposits. On the assumption that time deposits of IL 50,000 or more belong mainly to business concerns or institutions, which hold them instead of demand deposits, it turns out that time deposits owned by households expanded by 24.3 percent in 1972, compared with 35.4 percent the year before. (The slowdown is even more striking if we assume that the boundary is IL 10,000.) The expansion of larger deposits, on the other hand, accelerated from 20.5 percent in 1971 to 46.3 percent in the year reviewed.²⁴

The above data suggest that the adjustment of asset portfolios to the prevailing inflationary conditions was reflected in 1972 by a structural change in time deposit and Short-Term Loan holdings. The proportion held by households, evidently as a form of savings, has been shrinking with the switch to assets hedging the owner against inflation, while the share held by business enterprises, institutions, and organizations as part of their liquid funds has been on the rise.

²⁴ This analysis is incomplete since a similar breakdown of Short-Term Loan holdings is not available.

This development is attested by the shortening of the average period to maturity of Short-Term Loan certificates in circulation. In 1972 the three-month series accounted for 57 percent of total gross purchases of this paper, as compared with 48 percent in 1971, while the weight of the six-, twelve-, and eighteen-month series declined in the year reviewed.

The large volume of linked bonds falling due in 1972 calls for a discussion of their influence on the composition of the public's liquid assets portfolio. Such bonds could become an important component in the portfolio if demand for them would grow as the result of, say, a shift from time deposits; this would push up their price appreciably (reducing their yield) and induce those holding them as a savings instrument to sell them to those interested in holding them for liquidity purposes. However, the price and yield movements of these bonds, especially the 1967 Defense Loan, do not point to a significant decrease in yields as the paper approaches maturity.

The lack of a livelier demand for these bonds may be due to the fact that large segments of the public are unaware of the possibilities of obtaining an asset offering both high liquidity and index-linkage; another likely reason is that such paper is riskier than time deposits or the Short-Term Loan.²⁵

The interest rates paid on unlinked assets did not rise significantly in 1972. The yield on the Short-Term Loan remained unchanged, while that on time deposits rose only a notch, owing to two factors: First was the reduction of the at-source tax deduction on such deposits. To the depositor who does not have to pay additional tax on his interest income, this meant an increase of 0.25 of a percentage point in his yield; the depositor who is exempt from income tax does not benefit from this, of course. The second factor was the upping of the interest rate paid on large deposits of IL 100,000 or more by half a point (from 13 to 13.5 percent in the three big banks). This change was also introduced in the second quarter of 1972.

It is difficult to determine what proportion of the depositors benefited from both concessions. Some of the large deposit holders are enterprises or institutions exempt from tax (this explains their preference for time deposits over the Short-Term Loan), while most of the comparatively small depositors do not pay additional tax on their interest income; hence as far as these two groups are concerned, they enjoyed only a single increase in their net yield.

Developments in the two component groups of unlinked assets deserve special attention. In 1972 the outstanding balance of the Short-Term Loan rose only 4.4 percent, whereas time deposits soared 30.9 percent. The difference chiefly reflects developments in the second half of the year. Until August 1972 the

²⁵ An important component of the yield on the above-mentioned bonds is the profit accruing from "bond washing" (see note ⁸ on p. 428). This arrangement increases the risk of the investment (owing to its possible abolition by the tax authorities); in addition, only those familiar with the workings of the bond market are apt to recognize the potentialities of such an investment.

ratio between the two growth rates was similar to that of previous years, but it has since undergone a striking change: time deposits have continued to move up rapidly, while Short-Term Loan holdings of the public have begun to shrink, the level plunging precipitately in the last two months of the year and the first month of 1973.

It is difficult to attribute the latter development to the changes in the relative terms of this instrument and of time deposits. As already noted, the rise in the interest rate on time deposits was not substantial and it occurred in the second quarter of 1972. This suggests that the slump in Short-Term Loan sales was caused by the liquidity situation of the banking institutions during the months of November 1972–January 1973, when some tightness began to be felt in the money market (see section 3 above); a number of banking institutions incurred liquidity deficits and faced strong pressure from their clients for more credit. It is conceivable that in this situation the banking institutions directed some of their clients to time deposits instead of the Short-Term Loan.

This assumption is reinforced by the correlation found between the drop in new sales of this paper by the banks and their liquidity position in the last quarter of 1972, as well as by the resumption of the uptrend in sales since the middle of January 1973, when the new underwriting agreement between the banking institutions and the Bank of Israel went into force. This reversal of the sharply declining trend without major changes in the yield testifies to the banks' influence upon their clients' portfolio composition decisions.

(c) *Approved saving schemes*

The comparatively slow growth of approved saving schemes continued in 1972. Those administered by the banks increased by IL 269 million, as against IL 237 million in 1971. In contrast, there was a substantial expansion of saving plans for the purchase of homes, most of which are administered by the Ministry of Housing and mortgage banks; IL 65 million was accumulated in 1972—nearly double the 1971 figure.

The bank-administered schemes increased by 18.1 percent in 1972, compared with 19.1 percent the year before; together with the home-saving schemes, the rate was 20.6 percent as against 19.8 percent in 1971.

The relatively laggard development of saving schemes in recent years was discussed in previous *Annual Reports*. The same forces continued to operate in the year reviewed.²⁶ The accumulation in the ordinary (i.e. other than for housing) schemes is largely affected by developments in two close substitutes—index-linked bonds and provident funds for the self-employed. The data for 1972 indicate that there was again a lively demand for these types of saving instruments in comparison with approved saving schemes.²⁷

²⁶ See Bank of Israel, *Annual Report 1971*, pp. 315–16.

²⁷ For a detailed discussion of the demand for bonds and the accumulation in provident funds, see Chapters XVI and XVII below.

The yields on linked bonds did not change significantly in 1972. They may have declined somewhat, but remained appreciably higher than those on saving schemes. As explained in last year's *Annual Report*, at a time of strong inflation the liquidity of saving schemes is lower than that of linked bonds. It should be noted that an advantage hitherto possessed by saving schemes over bonds—the possibility of receiving current interest on one's savings—disappeared in 1972, when bonds were issued for a seven-year period and paying linked interest every six months—an innovation enhancing interest in direct investment in linked bonds. The formidable volume of bond transactions in recent years can probably be attributed to the attraction of many groups of savers who previously were not aware of the possibilities offered by this market. This development was mainly due to the large amount of capital raised through compulsory or semi-compulsory Absorption and Defense Loans since 1967, the brisk trade therein creating a widespread interest in the bond market.

6. SOURCES OF MONETARY EXPANSION

The rate of monetary expansion, as already noted, slackened in 1972, when the money supply and other liquid assets of the public grew by IL 3,046 million, or 22.5 percent, compared with 32.5 percent in 1971 (26.4 percent if the appreciation of the IL value of foreign currency deposits due to the devaluation is excluded).

The sources of the monetary expansion also underwent some change in the year reviewed. Whereas the money supply grew at roughly the same rate as in 1971, the uptrend in all other liquid assets sagged conspicuously.

The factors underlying these developments were as follows:

(a) The much smaller external infusions generated by the accumulation of foreign currency and the expansion of Bank of Israel credit to the Government and the Jewish Agency (see Table XIII-10). These infusions, which for the most part are beyond the control of monetary policy, were milder in 1972, since the Government's absorptive fiscal measures countered much of the influence of the sizable foreign currency accumulation.

It is difficult to compare developments during the past two years, since the data for 1971 reflect *inter alia* the appreciation of the IL value of foreign currency assets and the Government's debt due to the devaluation of the Israeli pound. But even if devaluation increments are ignored, the effect of the above-mentioned infusions was still greater in 1971. Here it should be noted that the devaluation of the Israeli pound, by also augmenting the IL value of Pazak and Tamam deposits and hence the wealth of their owners, was a very significant factor.

(b) The absorption policy of the Bank of Israel had a much greater effect on the money base than in previous years. It resulted in the mopping up of IL 183 million of the liquidity infused into the economy in 1972, despite

the larger volume of directed credit granted to finance the expansion of exports.

(c) Absorption through Short-Term Loan sales and the sterilization of Pazak and Tamam funds (another factor affecting the money base) was on a more limited scale in 1972. As explained above, the amount of liquidity siphoned off by way of the Short-Term Loan was fairly small, while the growth of Pazak and Tamam balances was slower than in 1971.

The net result of these three factors, which operated in different directions, was a noticeable deceleration in the external infusions and the expansion of the money base. The latter grew by 31.4 percent in 1972, compared with 43.2 percent the year before, while the external infusions (generated by foreign currency accumulation and the larger volume of credit supplied to the Government and the Jewish Agency) rose by 21.5 percent, as against 43.3 percent in 1971.

The connection between the external infusions (or the money base broadly defined) and total monetary expansion (the growth of the money supply and time deposits in local currency) is reflected by the monetary multipliers.²⁸ Table XIII-10 shows that there was no significant change in the size of the multipliers in 1972, following the previous year's decrease.

The stability of the money supply multiplier reflects a number of factors working in different directions. The first was the raising in 1972 of the liquidity ratios on time and demand deposits, which in itself should have depressed the money supply multiplier from 1.086 to 1.033. But the change in the banking institutions' liquidity position from a surplus of 3.8 percent of total demand deposits at the end of 1971 to a deficit of 1.3 percent at the end of 1972 increased the multiplier. Another factor working in this direction was the decline in the proportion of currency in the money supply.

The size of the total liquid assets multiplier (see column 8 in Table XIII-10) was influenced, in addition to these factors, by the reduced weight of Pazak and Tamam deposits and the Short-Term Loan in the total monetary expansion. Since the increase in these assets is entirely sterilized at the Bank of Israel, the size of the multiplier in this case is actually one.

What has been said above on the infusions and multipliers is also reflected in the changes in the weight in total monetary expansion of incremental local currency credit from the banks' own resources to the Government and the

²⁸ The multiplier is defined as the ratio between the balance of certain categories of liquid assets held by the public and the base for the creation of these assets. In this discussion we refer to two multipliers: the money supply multiplier, defined as the ratio between the money supply and the money base broadly defined (currency in circulation and all liquid assets held by the banking institutions); and the total liquid assets multiplier, defined as the ratio between the money supply plus other liquid assets of the public and the gross external infusions (i.e. the liquidity pumped into the economy through the accumulation of foreign currency or the granting of credit by the central bank to the Government, Jewish Agency, or the public).

Table XIII-10
EXTERNAL INFUSIONS AND MONETARY EXPANSION, 1969-72
(IL million)

	Infusions originating in accumulation of foreign currency and expansion of credit to the Govt. and Jewish Agency	Infusions originating in directed credit to the public ^a	Liquidity drains ^b	Money base, broadly defined (1+2+3)	Money supply	Total liquid assets held by the public	Money supply multiplier (5 ÷ 4)	Total liquid assets multiplier (6 ÷ [1+2])
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Balance at end of year								
1969	4,152	1,143	-2,848	2,447	2,970	8,517	1.21	1.61
1970	5,044	1,273	-3,401	2,916	3,385	10,233	1.16	1.62
1971	7,537	1,515	-4,877	4,175	4,341	13,563	1.04	1.50
1972	9,668	1,332	-5,516	5,484	5,587	16,609	1.02	1.51
Annual change								
1970	892	130	-553	469	415	1,716	0.88	1.68
1971	2,493	242	-1,476	1,259	956	3,330	0.76	1.22
1972	2,131	-183	-639	1,309	1,246	3,046	0.95	1.56

^a Rediscounts and exemptions from the liquidity requirements.

^b Mainly absorptions by way of foreign currency deposits and open-market operations.

SOURCE: Col. (1): Table XIII-4.

Col. (2): Credit to the public—Table XIII-4; liquidity exemptions—Table XIII-5.

Col. (4): Table XIII-5.

public. When its weight is on the rise, this generally tends to increase the multipliers. Table XIII-11 shows that the ratio between incremental bank credit to the public and the growth of the latter's liquid asset holdings went up from 20 percent in 1971 (26 percent if the devaluation increments on the public's foreign currency deposits are excluded) to 29 percent in 1972. The increase in this ratio, despite the stability of the multipliers, indicates that in 1972 the expansion of the banks' equity capital constituted an important source for expanding credit to the public. In other words, the larger volume of credit granted in the year reviewed is explained not only by the growth of the public's deposits but also by the funds raised through the issue of shares and capital notes.

(a) *Bank credit*

The increase in bank credit to the public slowed slightly in 1972, totalling IL 1,087 million, or 19.1 percent, compared with 21.9 percent in 1971 and 21.1 percent in 1970. This was the net result of a slightly faster growth of credit from the banks' own resources and a slower expansion of directed credit (see Table XIII-12). The former went up by IL 546 million, or 18 percent, as against 15.9 percent in 1971. Credit directed by the Bank of Israel rose by IL 343 million, or 16 percent, in 1972, after a 23.8 percent increase the year before. Foreign currency credit obtained outside the export funds (which requires permits from the Treasury's Foreign Exchange Department) grew by IL 193 million, or 38.2 percent, as opposed to 63.9 percent in 1971.

Credit developments during the year reviewed do not display a uniform trend; the demand and supply factors will therefore be analyzed separately for each six-month subperiod. The discussion will focus on credit from the banks' own resources, since changes in the volume of directed credit are largely determined by the Bank of Israel and the Government, and the influence of such credit on the economy's liquidity has already been discussed in section 3 above.

In the first half of 1972, and perhaps also in the third quarter of the year, demand for nondirected credit was not very heavy; this situation had been evident for more than a year, from the middle of 1971, and was the dominant factor in the money market developments.²⁹ Though the Bank of Israel took various steps to limit the supply of such credit, it seems that developments were dictated mainly by the relatively weak demand. This is attested by the large liquidity surpluses existing throughout most of the year and by the stability of debitory interest rates since the second half of 1971.³⁰ The reasons for the

²⁹ Between the end of June 1971 and the end of June 1972 nondirected credit expanded by only 10.6 percent. In August 1971 there was a sharp rise, connected with the expectations of an imminent devaluation, but subsequently demand waned.

³⁰ See the Bank Leumi le-Israel *Annual Report* for 1972, p. 15: "Since the economy was highly liquid during most of the year under review, demand for credit was on the low side and therefore could be met out of the means available without causing hardship to borrowers; indeed, during most of the year the banks had liquidity surpluses."

Table XIII-11
LIQUID ASSETS OF THE PUBLIC, BY SOURCE AND COMPONENT, 1969-72
 (IL million)

End of period	1969	1970	1971	1972	Percent annual increase or decrease (-)		
					1970	1971	1972
Sources							
Foreign currency assets	1,232.0	1,068.8	1,870.7	4,065.4	-13.2	75.0	117.3
With the Bank of Israel	1,196.7	1,225.5	2,299.1	4,688.7	2.4	87.6	103.9
With banking institutions	35.3	-156.7	-428.4	-623.3			
Credit from the Bank of Israel	3,621.4	4,556.1	6,117.5	5,838.0	25.8	34.3	-4.6
Credit to the Government ^a	2,799.7	3,693.2	5,112.9	4,564.6	31.9	38.4	-10.7
Rediscounts and loans							
To the Jewish Agency	128.0	124.9	125.0	415.7	-2.4	0.0	232.1
To the public	693.7	738.0	879.6	858.3	6.4	19.2	-2.4
Credit from banking institutions	3,585.3	4,558.3	5,511.0	6,787.9	27.1	20.9	23.2
To the Government	478.9	680.3	723.0	893.0	42.0	6.3	23.5
To the public							
In local currency	2,803.9	3,409.4	4,070.0	4,964.4	21.6	19.4	22.0
In foreign currency	302.5	468.6	718.0	930.5	54.9	53.2	29.6
Other factors, net	78.4	49.2	63.8	-52.5	-37.2	29.7	23.2
Total sources	8,517.7	10,232.4	13,563.0	16,608.8	20.1	32.5	—
Components							
Money supply	2,969.9	3,384.5	4,341.3	5,587.2	14.0	28.2	28.7
Less liquid deposits	5,080.0	6,288.8	8,507.5	10,276.4	23.8	35.3	20.8
Short-Term Loan	467.2	559.1	714.2	745.2	19.7	27.7	4.3
Total liquid assets held by the public	8,517.1	10,232.4	13,563.0	16,608.8	20.1	32.5	22.5

^a Revised data.

Table XIII-12
OUTSTANDING BANK CREDIT TO THE PUBLIC, BY COMPONENT, 1969-72
 (IL million)

End of period	1969	1970	1971	1972	Percent annual increase or decrease (-)		
					1970	1971	1972
(1) Nondirected local currency credit from the banking institutions	2,217.9	2,634.0	3,051.5	3,601.9	18.8	15.9	18.0
(2) Export and working capital funds	1,117.6	1,236.2	1,636.7	2,218.4	10.6	32.4	35.5
Bank of Israel rediscounts	523.6	580.7	729.8	670.1	10.9	25.7	-8.2
Within the framework of liquidity exemptions	199.2	224.9	307.7	428.9	12.9	36.8	39.4
Own resources	335.1	370.2	564.4	1,083.2	10.5	52.5	91.9
Government participation	59.7	60.4	34.8	36.2	1.2	-42.4	4.0
(3) Other credit within the framework of liquidity exemptions	250.1	311.6	327.6	45.0	24.6	5.1	-86.3
(4) Credit from saving scheme funds	36.1	26.0	29.9	35.7	-28.0	15.0	19.4
(5) Other Bank of Israel rediscounts	170.1	159.4	149.9	188.1	-6.3	-6.0	25.5
(6) Credit directed by the Bank of Israel (2 to 5 incl.)	1,573.9	1,733.2	2,144.1	2,487.2	10.1	23.8	16.0
(7) Foreign currency credit by banking institutions other than through the export and working capital funds	68.2	309.2	506.7	700.3	353.4	63.9	38.2
(8) Total credit from the banking system to the public (1+6+7) ^a	3,860.0	4,676.4	5,702.3	6,789.4	21.1	21.9	19.1

^a The figures here are somewhat larger than those in Table XIII-11 as they include credit granted from Government deposits in the export and working capital funds.

relatively weak demand for credit in 1972 were much the same as for the previous year—namely the abundance of liquidity in the economy due to the sizable private capital import and the much larger volume of medium- and long-term credit supplied by financial institutions. The structure of Israel's money and capital market makes nondirected bank credit virtually the sole source of institutional financing. Its price is determined by demand and supply conditions, unlike the subsidized price of most other sources of funds; accordingly, the demand for nondirected credit is affected both by the availability of funds from other sources and by the volume of transactions in the various markets.

Table XIII-13

FUNDS SUPPLIED THROUGH THE MAJOR LIQUIDITY SOURCES, 1970-72

(IL million)

	1970	1971	1972	Percent annual increase or decrease (-)	
				1971	1972
				Banking institutions ^a	693
Foreign investments and long-term loans ^b	144	784	136	444.4	19.4
Foreign transfers to individuals and nonprofit institutions ^c	836	1,524	2,020	82.2	32.5
Directed bank credit in IL and foreign currency ^d	400	609	536	52.2	-12.0
Total funds other than nondirected bank credit	2,073	4,026	5,192	94.2	29.0
Nondirected bank credit	416	417	551	0.0	32.1

^a Credit granted by the financial institutions to the various sectors (excluding credit to the Government and the financial sector).

^b Data from Chapter III, less the sums granted to the financial institutions and the Government.

^c Excluding personal restitution receipts.

^d Data from Table XIII-12.

The supply of funds from other sources rose appreciably in 1971 and 1972. Though the data in Table XIII-13 are incomplete—they do not include credit granted by the Government and social insurance funds to the rest of the economy—they indicate a big increase in funds from all sources other than the banks' free reserves during the years 1971-72. An increase in such financing weakens the demand for nondirected credit in two ways: First of all, it directly diminishes the recourse to bank financing by those obtaining credit or other funds from financial institutions, overseas sources, or the directed credit funds; this applies to industrial and other enterprises, the construction sector, hotel trade, and even families purchasing homes. The second is an indirect influence: the ample liquidity originating in these sources tends to increase the amount of available

Table XIII-14
OUTSTANDING CREDIT GRANTED TO THE PUBLIC BY THE BANKING SYSTEM, 1970-72^a
 (IL million)

End of period	Nondirected credit in Israeli currency	Credit directed by the Bank of Israel	Foreign currency credit from banking institutions other than through the export funds ^b	Total bank credit to the public (1+2+3)	Credit from earmarked deposits of the public ^c	Credit against Govt. deposits	Credit from ear- marked Govt. deposits ^d
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	2,634.0	1,733.2	309.2	4,676.4	1,424.7	95.6	809.6
1971	3,051.5	2,144.1	506.7	5,702.3	2,136.6	144.1	977.6
1972	3,601.9	2,487.2	700.3	6,789.4	3,060.6	164.4	1,101.3
1972 January	2,985.3	2,236.1	479.3	5,700.7	2,216.8	147.5	1,010.8
February	2,964.9	2,246.6	558.1	5,769.6	2,284.9	163.6	1,037.2
March	3,275.1	2,232.3	588.7	6,096.1	2,366.1	185.6	1,022.1
April	3,083.9	2,248.6	552.9	5,885.4	2,377.3	181.9	1,035.1
May	3,111.9	2,156.0	588.8	5,856.7	2,415.0	177.9	1,045.4
June	3,170.1	2,218.8	625.8	6,014.7	2,525.6	174.7	1,045.8
July	3,188.4	2,243.3	641.3	6,073.0	2,550.5	165.8	1,060.7
August	3,176.7	2,273.4	597.2	6,047.3	2,594.8	151.4	1,066.8
September	3,341.5	2,274.9	617.2	6,233.6	2,648.2	162.8	1,079.8
October	3,400.8	2,370.5	645.9	6,417.2	2,712.7	161.9	1,069.8
November	3,576.2	2,440.8	703.1	6,720.1	2,798.6	166.4	1,072.4
December	3,601.9	2,487.2	700.3	6,789.4	3,060.6	164.4	1,101.3

^a See the note to Table XIII-12. The three types of bank credit in this table are defined in the same way as in Table XIII-12.

^b Domestic credit only.

^c Mainly credit from earmarked deposits of social insurance funds and financial institutions.

^d Less credit from Government deposits in the working capital funds.

suppliers' and customers' credit, thereby dampening the demand for non-directed bank credit, even by business establishments not directly benefiting from the larger volume of liquid funds obtained from abroad or from the financial institutions.

In 1972 another factor may have been at work here, namely the drawing down of stocks in various sectors of the economy; however, the data on this are not sufficiently clearcut to reach a definite conclusion.

The combined effect of the factors listed above was a sluggish growth in non-directed credit in the first half of 1972—a total of IL 120 million, or only IL 20 million a month (see Table XIII-14).

Besides the comparatively weak demand for nondirected credit, its growth was affected by a number of supply factors. The absorptive measures of the Bank of Israel and the 16 percent interest paid on liquidity surpluses during this period, both designed to arrest the expansion of such financing, presumably prompted the banks to act with some restraint in the use of their free resources.

In the second half of 1972 demand for nondirected credit picked up, and the balance increased by IL 426 million (IL 71 million a month), or 13.5 percent—a development that became more pronounced in the first quarter of 1973. It is difficult to determine the exact month in which the turning point was reached in the money market. The weekly nondirected credit series shows a steep jump since mid-September (the High Holiday season), but in the absence of information on the seasonal pattern of such credit, it is difficult to say if the turnabout in fact occurred in the third quarter of the year. Nevertheless, it is obvious that the brisker demand for credit coincided with a sharp contraction of the external infusions and the slower growth of the money base. This connection between the demand for credit and the expansion of the money base attests to the substitutability of the various sources of liquid funds. To be sure, the deceleration of the money base was already evident in June, but it is reasonable to assume that such a development has a lagged effect on credit demand, especially as business activity invariably falls off during the summer holiday period.

In addition to these demand factors, two other influences were at work in the second half of 1972.

The first was connected with the delay and postponement of payments to various suppliers by the Accountant General. This led to the creation of a budgetary surplus, but at the same time it increased the demand for credit by the suppliers affected. The second factor was the expectation of a further spiralling of prices, as borne out by several indicators.

The latter factor, combined with the stability of debitory interest rates, caused borrowers to anticipate a decline in real interest rates, thereby resulting in a heavier demand for bank credit.

The sizable liquidity surpluses held by the banks before this change of

Table XIII-15
SECTORAL DISTRIBUTION OF BANK CREDIT, 1971-72^a
(IL million)

Sector	December 31, 1971					December 31, 1972				
	Banking institution and Bank of Israel credit			From ear- marked deposits ^c	Total	Banking institution and Bank of Israel credit			From ear- marked deposits ^c	Total
	Non- directed	Directed (in IL and foreign currency) ^b	Total			Non- directed	Directed (in IL and foreign currency) ^b	Total		
Agriculture	157.9	351.1	509.0	129.5	638.5	183.0	476.8	659.8	161.7	821.5
Industry	914.3	1,671.5	2,585.8	434.3	3,020.1	1,023.5	1,825.7	2,849.2	602.1	3,451.3
Electricity and water	15.8	63.6	79.4	154.1	233.5	29.0	73.6	102.6	154.0	256.6
Construction	285.7	36.0	321.7	240.4	562.1	320.1	41.9	362.0	305.5	667.5
Services	953.0	310.6	1,263.6	1,144.4	2,408.0	1,149.5	509.4	1,658.9	1,478.0	3,136.9
Public services ^d	318.3	36.9	355.2	981.8	1,337.0	393.3	25.1	418.4	1,224.5	1,642.9
Other	455.3	13.4	468.7	261.9	730.6	608.0	29.5	637.5	409.7	1,047.2
Sundry	74.3	3.7	78.0	9.2	87.2	85.4	17.3	102.7	23.0	125.7
Private individuals	380.9	9.8	390.7	252.7	643.4	522.6	12.3	534.9	386.6	921.5
Total	3,100.3	2,483.1	5,583.4	3,346.4	8,929.8	3,706.4	2,982.0	6,688.4	4,335.5	11,023.9
Errors and omissions	-48.8	167.7	118.9	-88.1	30.8	-104.5	205.5	101.0	-9.2	91.8
Net total	3,051.5	2,650.8	5,702.3	3,258.3	8,960.6	3,601.9	3,187.5	6,789.4	4,326.3	11,115.7

^a New series.

^b Includes credit directed by the Bank of Israel and foreign currency credit to Israeli residents other than through the directed credit funds.

^c Credit from earmarked deposits of the public, the Jewish Agency, and the Government that is not defined as bank credit.

^d Excludes Bank of Israel credit to the Jewish Agency.

trend enabled them to meet the mounting demand for credit despite the sluggish growth of their liquid assets. Between the last Wednesday in August and the last Wednesday in December nondirected credit was expanded by IL 300 million,³¹ heavily depleting the banks' free reserves; in the first quarter of 1973 they stepped up their credit operations to an even greater extent.

Since the banks' response to the brisker credit demand was not accompanied by an increase in liquidity, the money market became much tighter. However, it should be added that the stringent monetary measures adopted in 1972 and the smaller foreign currency accumulation in the second half of the year had only a limited effect on nondirected bank credit, since the liquidity surpluses existing at the end of 1972 and the funds raised through share and capital note issues enabled the banking institutions to meet the increased demand for credit in the last six months of the year reviewed. This demand was not accompanied by the hiking of interest rates on such credit. This may have been connected with the feeling that the tight money situation was a passing phenomenon, and with the strong public pressure on the banking institutions to refrain from upping interest rates. However, it should be noted that interest was raised by up to two points on unauthorized overdrafts. Though no data are available on such overdrafts, it is reasonable to assume that they have been on the rise since the last quarter of 1972. With the disappearance of the liquidity surpluses at the end of 1972 and the forecast that the crunch on money would persist in the following year, the Bank of Israel decided to stop paying 16 percent interest on liquidity surpluses. Under the prevailing tight credit conditions, the payment of this rate of interest ceased to have a restraining influence on the expansion of credit to the public; its discontinuation therefore had no effect on the credit market.

Together with the nondirected credit developments, significant changes were introduced in the system of directed bank credit with a view to moderating its expansionary effect.

The structure of the working capital funds was altered and the rate of interest hiked from 9 to 11 percent. The latter step was taken because of the rapid spiralling of prices since August 1970, which has far outpaced the rise in nominal interest on such credit. Besides reducing the negative real interest which borrowers enjoyed, the raising of the interest rate made it possible to increase the banking institutions' participation in the working capital funds from their free resources. In the case of several of the major funds, this meant that the Bank of Israel ceased to be the sole source of their resources. This applies to the citrus and cotton funds, where the banks' participation now amounts to only 25 percent, the agricultural working capital fund (45 percent), and the general fund (50 percent). Following these structural changes, most of the

³¹ The use of Wednesday data for the comparison is intended to eliminate the seasonal jump at the end of December, when overdraft accounts are charged interest for the quarter.

outstanding credit in the form of liquidity exemptions was transferred to these funds. Whereas at the end of 1971 the volume of liquidity exemptions outside these funds reached IL 328 million, it totalled only IL 45 million at the end of 1972 (see Table XIII-12).

These structural changes were accompanied by action to prevent the excessive growth of the funds, which does not accord with the purposes for which they were established. This is evidenced by the more sluggish growth of the balance of Bank of Israel directed credit.

The moves taken to check the expansion of the funds were part of the Bank's policy of monetary stringency, but even after the banks' participation was stepped up in 1972 the Bank of Israel continued to supply about half the resources. In other words, about half the growth of these funds represented the creation of money by the Bank of Israel.

Another striking development was the continued strong increase in foreign currency credit obtained by Israeli residents outside these funds, under permits issued by the Treasury's Foreign Exchange Department.³² While the expansion of such credit slowed in 1972, it was still quite substantial, especially in the first half of the year. There was a brisk demand for such financing in 1971 and 1972 owing to the sizable differential between local and foreign interest rates and the absence of expectations of an early devaluation of the Israeli pound. The restrictive credit policy, as already mentioned, succeeded in moderating the uptrend in the second half of the year.

Table XIII-15 gives the sectoral distribution of the various types of credit supplied to the public. In nondirected credit there was an appreciable increase in the proportion granted to private individuals and to the service sectors. This was connected with the relatively weak demand for nondirected credit by industry, agriculture, and construction. These sectors possessed ample liquid funds in 1972 as a result of foreign currency transfers and a much larger volume of medium- and long-term directed credit, and hence they did not have to resort more heavily to nondirected credit. The banking institutions were therefore able to greatly step up their lending to private individuals and to the service sectors to meet their mounting demand for credit (which was especially brisk in the case of private individuals) to finance the growth of consumer and other business activity in the economy. Presumably much of the incremental credit received by private individuals was intended for financing securities transactions.

(b) *Credit to the Government*

The Government's debt to the banking system contracted for the first time since 1963. It repaid IL 548 million in Bank of Israel credits while increasing its liabilities to banking institutions by IL 170 million.

³² The demand for foreign currency financing from abroad and from local banks is discussed in Chapter III.

Table XIII-16
**CHANGES IN OUTSTANDING CREDIT FROM THE BANKING SYSTEM
 TO THE GOVERNMENT AND NATIONAL INSTITUTIONS, 1970-72**
 (IL million)

End of period	From the Bank of Israel			From banking institutions				Total change in credit from the banking system (3+7)
	Credit granted to the Govt. ^a	Less:	Total	Credit granted to the Govt. ^b	Investment in Govt. securities ^c	Less:	Total	
		Increase or decrease (-) in Govt. and National Institution deposits				Increase or decrease (-) in Govt. deposits		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
1970	1,039.9	146.2	893.7	124.8	95.8	19.3	201.3	1,095.0
1971	1,439.1	17.6	1,421.5	-52.0	106.6	11.8	42.8	1,464.3
1972	-190.7	357.5	-548.2	83.7	66.9	-19.1	169.7	-378.5
1972 January	135.7	41.9	93.8	-9.5	14.3	-28.5	33.3	127.1
February	-193.3	-84.4	-108.9	-1.5	20.5	5.1	13.9	-95.0
March	-415.3	113.8	-529.1	5.5	20.0	-44.2	69.7	-459.4
April	75.7	-31.6	107.3	13.7	17.0	50.7	-20.0	87.3
May	47.4	-6.8	54.2	24.3	25.4	-0.5	50.2	104.4
June	39.9	-36.0	75.9	3.1	-8.2	1.6	-6.7	69.2
July	17.6	4.4	13.2	0.9	1.0	-4.8	6.7	19.9
August	53.0	94.3	-41.3	-5.6	18.2	0.6	12.0	-29.3
September	54.1	62.4	-8.3	19.0	-13.1	-7.8	13.7	5.4
October	6.1	74.2	-68.1	27.9	0.9	2.6	26.2	-41.9
November	5.2	17.5	-12.3	-20.4	1.4	-0.1	-18.9	-31.2
December	-16.8	107.8	-124.6	26.3	-30.5	6.2	-10.4	-135.0

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

^b In Israeli currency only. Including banking institution deposits with the Treasury in connection with approved saving schemes of the type involving the deposit of Absorption Loan certificates.

^c Excluding changes in holdings of treasury bills and the Short-Term Loan (for reasons that are explained in note ^a to this table). Government securities sold to the Bank of Israel under the optional repurchase arrangement have also been excluded.

The trimming of the Government's indebtedness to the Bank of Israel was the result of deliberate action by the Treasury, which augmented its domestic revenue through taxes and the sale of bonds while postponing the execution of development projects and disbursements to suppliers.

This decline in liabilities to the Bank of Israel was one manifestation of the influence exerted by the Government budget upon the economy's liquidity and the balance of payments. Additional factors to be taken into account are the foreign currency conversions by other public sector authorities (especially the Jewish Agency) and the functional composition of Government budgetary outlays.

To the decrease in the Government's debt to the Bank of Israel must be added the purchase of foreign currency to the tune of IL 1,280 million for effecting payments abroad. The foreign currency, obtained from the Bank of Israel, was paid for out of the Government's domestic revenue, thus contributing to the absorption of liquidity. But these foreign currency purchases are also reflected by a rise in various Government outlays in the country's goods and services account, as well as in the servicing of the external debt.

A different definition of the Government's liquidity absorption excludes the foreign currency purchased from the Bank of Israel for financing food imports, since the food is intended for consumption by the nongovernmental sector and the Government's role here is akin to that played by private importers in other spheres. According to this definition, the amount of funds mopped up by the Government in 1972 was IL 720 million less than cited above—i.e. IL 560 million instead of IL 1,280 million.

Part of the increase in the Government's domestic revenue stemmed from the sale of its bond issues; this in itself largely reflected the rapid monetary expansion, which was fueled by the accumulation of foreign currency assets and led to a livelier demand for linked fixed-interest securities. The same applies to direct and indirect tax revenue, which rose along with nominal income and domestic demand. But by refraining from pumping back into the economy the incremental revenue connected with the inflationary situation besetting the country this year, the Government helped to keep down demand pressures and absorb liquidity.

In contrast to these two absorptive measures, the National Institutions infused IL 1,095 million into the economy through the conversion of their receipts from abroad.

The total amount of liquidity absorbed by the Government and the Jewish Agency in 1972 came to IL 733 million according to the first definition (but only IL 14 million according to the second); this compares with an infusion of IL 84 million in 1971 (IL 720 million according to the second definition).

As already noted, the holding up of payments to Government suppliers apparently intensified the demand for nondirected credit in the second half of 1972. Hence not all of the Government's demand was reflected by the injection

Table XIII-17
FOREIGN CURRENCY ASSETS AND LIABILITIES OF THE BANKING SYSTEM, 1970-72
(IL million)

End of period	Bank of Israel				Banking institutions			
	Foreign currency assets	Foreign currency liabilities		Net assets (1-2-3)	Foreign currency assets ^c	Foreign currency liabilities		Net assets (5-6-7)
		Patach deposits ^a	Other liabilities ^b			Patach deposits ^d	Other liabilities ^e	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
1970	1,791.0	209.8	355.7	1,225.5	1,799.8	1,022.9	933.6	-156.7
1971	3,355.2	613.9	442.2	2,299.1	3,343.0	1,823.7	1,947.7	-428.4
1972	5,718.0	656.8	372.6	4,688.7	5,326.0	2,499.1	3,450.2	-623.3
1972 January	3,531.4	665.4	497.8	2,368.2	3,278.1	1,994.1	1,697.0	-413.0
February	3,982.4	678.2	498.3	2,805.9	3,443.9	1,846.9	2,097.8	-500.8
March	4,591.5	698.7	471.4	3,421.4	3,605.1	1,860.7	2,239.9	-495.5
April	4,877.4	667.2	471.4	3,738.8	3,308.6	1,869.4	1,942.2	-502.9
May	5,081.0	651.1	491.6	3,938.3	3,206.2	2,018.8	1,698.2	-510.8
June	5,210.8	652.9	512.1	4,045.8	3,261.5	2,055.8	1,726.5	-520.7
July	5,386.4	675.9	512.9	4,197.6	3,474.8	2,009.2	1,994.6	-529.1
August	5,401.2	654.3	517.7	4,229.2	3,657.6	2,100.3	2,039.7	-482.5
September	5,401.3	641.5	516.6	4,243.2	3,961.6	2,148.3	2,291.4	-478.1
October	5,360.5	598.0	373.3	4,389.2	4,439.7	2,251.1	2,740.5	-551.9
November	5,441.5	588.1	373.5	4,479.9	4,886.9	2,305.3	3,204.6	-623.0
December	5,718.0	656.8	372.6	4,688.7	5,326.0	2,499.1	3,450.2	-623.3

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

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

^c Mainly deposits with foreign banks; excludes domestic credit in foreign currency.

^d Nonresidents' deposits, less sums redeposited with the Bank of Israel.

^e Mainly deposits and loans from foreign banks, less net foreign currency loans to the Government.

of liquidity into the economy, and this made it necessary to use data on Government expenditure as the principal indicator of its influence upon economic activity (see the discussion in Chapter VII).

The Government's debt to the banking institutions grew in 1972 by IL 170 million, of which IL 67 million represented purchases of Government securities and IL 103 million net local currency credit granted to the Government (i.e. credit less deposits).

The banks apparently continued to sell bonds from their own portfolio in 1972. This is indicated by the fact that purchases of the Defense Loan totalled IL 129 million this year, while their Government bond portfolio grew by only IL 67 million.

(c) *Foreign currency assets*

Net foreign currency assets held by the Bank of Israel were, at \$ 1,116 million, up \$ 569 million—a much bigger increase than in the two preceding years (\$ 197 million in 1971 and \$ 8 million in 1970). Most of the increment was reflected in the foreign exchange reserves held at the Bank, which expanded by \$ 494 million to reach \$ 1,070 million at the end of 1972.³³

The factors behind the expansion of foreign currency assets were discussed in Chapter III, and the changes in the component items in Chapter XVIII.

Of the total increase in foreign currency asset holdings, \$ 12 million represented the rise in the value of gold and of assets denominated in European currencies. During the year Israel drew \$ 35 million on its credit tranche in the IMF.

The rapid uptrend in the banking institutions' foreign currency transactions continued in 1972, when \$ 529 million was obtained from foreign banks and nonresidents, compared with \$ 421 million in 1971. Of this sum, \$ 10 million was deposited in the Bank of Israel to provide liquid backing against these liabilities, while \$ 519 million remained at the disposal of the institutions for granting credit. Of the total foreign currency credit, \$ 472 million was invested abroad, while \$ 47 million was brought to Israel on the strength of special permits issued by the Treasury and the Examiner of Banks at the Bank of Israel. Most of the foreign currency credit granted by banks to Israeli clients was not connected with the export funds but was extended in response to the strong demand for such finance because of the big differential between its price and that of nondirected credit in Israeli currency. Table XIII-14 shows that in the second half of 1972 the expansion of foreign currency credit to Israeli residents from sources outside the export funds slowed noticeably, thanks to the Treasury's policy of checking its growth.

³³ The foreign currency balances held at the Bank of Israel consist of gold, Special Drawing Rights, deposits and other liquid investments of the Bank, less deposits of foreign banks with the Bank of Israel and that part of the Patach deposits that is redeposited with the Bank.

7. THE DEVELOPMENT OF BANKING INSTITUTIONS

The combined balance sheet of the banking institutions³⁴ expanded by IL 8,658 million, or 33.5 percent, in 1972, compared with IL 8,804 million (51.1 percent) the year before. The 1972 growth rate was similar to that in 1970 (31.1 percent) but slower than in 1971, when it was affected by the devaluation of the Israeli pound.

The main factors in the balance sheet increase were the rapid monetary expansion, the much larger volume of institutional and Government deposits earmarked for loans, the receipt of deposits and loans from abroad by the banks, and the raising of funds through capital note and share issues.

The monetary expansion was reflected by the swelling of demand and time deposits, as well as by the continued expansion of saving schemes and Pazak and Tamam foreign currency deposits. While the growth of Pazak and Tamam accounts was slower than in the previous year, it should be recalled that they had increased very rapidly after the devaluation of the Israeli pound and the dollar.

The expansion of the banks' foreign currency transactions was reflected by an increase in their foreign liabilities to the tune of IL 2,178 million (\$ 519 million), or 57.8 percent. The use of these funds was discussed in section 6 (c) above.

Earmarked deposits of approved institutions rose by IL 2,394 million, or 41.3 percent, with the bulk of the sum, as well as of the loans granted therefrom, being concentrated in a small number of concerns. Earmarked Government deposits increased by only IL 145 million, or 12.5 percent.

The banks' equity capital plus their capital note issues increased by IL 365 million, or 68.5 percent, in 1972. The increment includes IL 136 million obtained from share issues and IL 144 million from the sale of capital notes; the balance represents undistributed profits and transfers to reserves.

These changes depressed the weight of demand deposits, IL time deposits, and saving scheme balances in total liabilities, and brought up the weight of earmarked deposits and foreign liabilities.

On the assets side, there was a rise in the proportion of foreign currency assets and of loans from earmarked deposits of the public (mainly of financial institutions and social insurance funds), while the weight of credit from the banks' own resources declined.

The substantial increase in Israeli currency liquid assets and the relatively slow growth of bank credit from the institutions' own means reflected the sizable external infusions on the one hand and the Bank of Israel's policy of monetary restraint on the other.

The number of banking institutions was reduced by three in 1972: the

³⁴ The combined balance sheet of the banking institutions, presented in Table XIII-18, was revised in 1972 in order of fit, as far as possible, the various deposit and credit items to the definitions used in this chapter.

Table XIII-18
ASSETS AND LIABILITIES OF BANKING INSTITUTIONS, 1969-72*
 (IL million)

End of period	1969	1970	1971	1972
Assets				
Liquid IL assets at the Bank of Israel ^b	853.4	1,102.2	1,958.0	3,029.0
Foreign currency deposits with the Bank of Israel ^c	2,334.9	2,782.1	4,119.8	4,724.5
Foreign currency assets	1,114.6	1,799.8	3,343.0	5,326.0
Credit to the public from the banks' own means	3,106.4	3,878.0	4,787.9	5,894.9
Deposits with financial institutions and investment banks	4.3	12.2	7.4	25.6
Credit to the public from deposits approved for loan purposes	972.4	1,424.7	2,136.6	3,060.6
Credit to the public from Govt. deposits	760.1	965.6	1,156.5	1,301.9
Securities	636.7	764.1	907.7	1,169.9
Premises and equipment	132.3	160.6	204.6	263.5
IL loans to the Govt.	89.4	214.1	162.1	245.9
Government bonds	414.6	510.4	617.1	684.0
Loans to the Govt. from earmarked deposits	271.4	440.2	785.0	1,522.5
Balances in transit and deposits in banking institutions	47.0	110.4	136.6	219.0
Other accounts	550.0	741.7	1,162.6	1,675.7
Total assets	11,288.0	14,905.9	21,485.1	29,143.0

Liabilities

Equity capital and capital notes	432.0	461.7	532.6	897.9
Foreign liabilities	1,079.3	1,956.4	3,771.4	5,949.3
Demand deposits	1,841.3	2,103.8	2,756.9	3,613.3
Foreign currency deposits of the public	2,401.9	2,886.2	4,149.8	4,750.2
Time deposits and bill brokerage	1,672.6	2,157.2	2,874.8	3,774.8
Approved saving schemes	1,005.4	1,245.2	1,482.6	1,751.5
Deposits of financial institutions and investment banks	29.6	76.9	97.0	130.8
Approved earmarked deposits ^d	1,269.8	1,896.6	2,987.2	4,692.7
Earmarked Govt. deposits ^e	760.1	965.6	1,156.5	1,301.9
Government accounts	25.1	44.3	56.2	36.9
Banking institution deposits	44.5	111.8	169.7	249.0
Other accounts	726.4	1,000.2	1,450.4	1,994.9
Total liabilities	11,288.0	14,905.9	21,485.1	29,143.0
Sundry accounts ^f	578.3	811.7	2,444.0	2,649.6
Contingent accounts ^g	1,110.8	1,324.5	1,917.3	2,712.3
Total	12,977.1	17,042.1	25,846.4	34,504.9

^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 vault cash.

^c Less Patach funds deposited with the Bank of Israel.

^d Deposits used for granting loans.

^e Includes demand and time deposits and unutilized earmarked Govt. deposits.

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

^g Acceptances, guarantees, and documentary credits.

Table XIII-19
SELECTED INDICATORS OF THE CONCENTRATION OF BANKING
BUSINESS, 1970-72^a

(percentages)

End of period	The Big Three	Subsid- iaries of the Big Three ^b	Other banks	Credit cooper- atives	Total
Cash and balances with the Bank of Israel					
1970	64.5	4.5	26.4	4.6	100.0
1971	67.4	5.6	22.9	4.1	100.0
1972	70.9	9.5	16.3	3.3	100.0
Loans to the public ^c					
1970	63.4	10.5	22.6	3.5	100.0
1971	64.3	10.5	22.6	2.6	100.0
1972	68.2	13.1	16.6	2.1	100.0
IL deposits of the public					
1970	69.2	3.4	23.5	3.9	100.0
1971	72.0	4.4	19.8	3.8	100.0
1972	73.1	8.5	15.1	3.3	100.0
Foreign currency deposits of the public ^d					
1970	82.0	4.7	13.2	0.1	100.0
1971	82.9	4.6	12.4	0.1	100.0
1972	84.0	7.1	8.8	0.1	100.0
Number of head offices and branches					
1970	56.9	1.0	33.6	8.5	100.0
1971	62.3	3.8	25.4	8.5	100.0
1972	64.8	12.8	15.5	6.9	100.0

^a The data do not include the Israel Bank of Agriculture.

^b In 1970 the Union, Japhet, and Mercantile banks; in 1971 also includes the Arab-Israel Bank, and in 1972 Barclays-Discount Bank.

^c Excludes credit from deposits earmarked for loans.

^d Includes deposits of nonresidents (Patach).

Agudath Israel Bank was bought out by Bank Leumi le-Israel, the Export Bank and the Foreign Trade Bank merged to form the First International Bank of Israel, and Halva'a Vehisachon Haifa (a credit cooperative) merged with Bank Leumi.

The number of bank branches increased by 12 in 1972, compared with 19 the year before.

Table XIII-19 shows a continuation of the trend toward the centralization of banking business, due both to the expansion of operations by the big banks and the rise in the number of affiliated banks.

8. OPERATING RESULTS OF THE BANKING INSTITUTIONS

The expansion of banking institution operations in 1972 was accompanied by an increase in their income, expenditure, and profits.

Income from interest and linkage increments grew by 36.8 percent, owing both to the larger volume of loans granted and to the rise in interest rates. Another contributory factor was the increased weight of credit from earmarked deposits in total commercial bank loans—the nominal interest on such credit (including linkage increments) is higher than the average rates charged on bank credit.

Income from interest on deposits with the Bank of Israel and other banks was up 55.7 percent, owing to the 55 percent growth of local currency deposits with the central bank in the wake of the big liquidity infusions and to the 20 percent increase in foreign currency deposits. The raising of the liquidity ratios in 1972 was accompanied by a 1.5 percentage point hike in the average rate of interest paid by the Bank of Israel on local currency deposits and a slight reduction of the rate on foreign currency deposits.

The appreciable 46.4 percent growth of income from service charges is largely explained by the bigger volume of securities transactions executed for the banks' clients this year. There was also a big increase in commissions earned on clients' foreign currency transactions, which was apparently connected with the change in the nature of these transactions following the floating of foreign exchange rates.

"Other income", which includes the banks' earnings on securities transactions from their own portfolio and transactions carried out on own account, also rose rapidly in 1972, but not as much as in the previous year.

Along with the 41.6 percent gain in income, expenses went up 37.9 percent. There was a particularly steep 43.1 percent rise in compensation of employees (salaries and wages and fringe benefits); this is a much higher rate than in 1971, and it also far eclipsed the percentage increase in operating income and other operating expenses.

Profitability measures show a notable rise in profits relative to equity capital. The ratio of operating profit to equity capital went up from 34 percent in 1971 to 45.4 percent, despite the substantial growth of the banking institutions' capital resources this year. Calculated in relation to equity capital plus capital notes, the increase was slower—from 28.7 to 30.7 percent.³⁵

³⁵ A detailed analysis of the banking institutions' income and expenses will appear in a survey to be published by the Department of the Examiner of Banks.

Table XIII-20

OPERATING RESULTS OF BANKING INSTITUTIONS,^a 1971-72

	IL million		Percent		Percent annual increase or decrease (-)		
	1971	1972	1971	1972	1971	1972	
Operating income							
Interest and linkage differentials on loans	1,163.9	1,592.7	55.5	53.6	66.9	36.8	
Service charges	179.0	262.1	8.5	8.8	14.4	46.4	
Interest on deposits with the Bank of Israel and other banks	443.7	690.9	21.1	23.3	79.1	55.7	
Other income ^b	311.8	424.8	14.9	14.3	87.5	36.2	
Total	2,098.4	2,970.5	100.0	100.0	65.5	41.6	
Operating expenses							
Payroll	294.9	422.0	15.0	15.6	26.5	43.1	
Interest on deposits ^c	1,524.5	2,092.8	77.5	77.2	82.0	37.3	
Other expenses ^d	146.6	196.6	7.5	7.2	29.5	34.1	
Total	1,966.0	2,711.4	100.0	100.0	66.0	37.9	
Profits							
Operating profits	132.4	259.1	86.6	102.4	58.2	95.7	
Other profits (net)	20.5	-6.1	13.4	-2.4	—	—	
Total profit before tax	152.9	253.0	100.0	100.0	72.7	65.5	
			1968	1969	1970	1971	1972
Pretax profit ratios							
Operating profit as a percentage of operating income			8.4	9.0	6.6	6.3	8.7
Operating profit as a percentage of equity capital			17.5	21.7	21.4	34.0	45.5
Total profit as a percentage of equity capital			17.8	23.1	22.0	35.9	44.3
Operating profit as a percentage of equity and capital notes ^e			16.1	19.1	19.5	28.7	30.7

^a Data for 1972 are provisional.

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

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

^d Including administrative overheads, depreciation, donations, and bad debts.

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