

CHAPTER XVI

MAIN DEVELOPMENTS IN THE MONEY AND CAPITAL MARKETS

In 1978 the public continued to switch to the new asset and credit channels opened up with the foreign currency reform in the final part of 1977. During the year the Bank of Israel had to cope with the stronger relationship created by the reform between monetary policy and the balance of payments. Monetary-financial expansion was sustained in real terms¹ during the year; however, there were changes in its composition, the most prominent being an increase in the share of foreign currency assets and liabilities in the public's portfolio and a relative drop in the volume of long-term saving in the various plans administered by the commercial banks. While the real monetary-financial expansion was not as fast as in 1977, the deceleration was not sufficient to blunt the stimulative effect of the monetary variables on economic activity and prices in the year reviewed.

The foreign currency reform consisted of three basic elements, which left their stamp on monetary developments in 1978 and forced policy-makers to come to grips with them. (a) The liberalization of foreign currency control, which enabled the public to hold foreign currency assets and to obtain nondirected credit in foreign currency, made the Israeli economy more open to the international money market, increasing the array of assets and liabilities with monetary significance and greatly diminishing the ability of the monetary authorities to maintain a substantial differential between domestic interest rates and the expected price of nondirected foreign credit (the interest rate in foreign currency terms plus the anticipated change in the rate of exchange).² (b) The Israeli pound was floated, thereby terminating the Bank of Israel's obligation to buy and sell any amount of foreign currency requested (for approved purposes) or offered at the exchange rate set by the authorities. The floating of the Israeli pound in itself could have isolated the development of the money base in local currency from private capital movements, but in fact it created

¹In this chapter the term "real" refers in the case of assets to their nominal value deflated by the consumer price index, to short-term credit deflated by the implicit price index of resource uses, and to long- and medium-term credit deflated by the index of investment prices.

² It should be noted that in the past too the domestic money market was not completely divorced from the international markets, and that even after liberalization the international interest rates and exchange rate expectations did not fully determine the domestic free market rate, but rather they narrowed the limits within which it could range.

a close connection between domestic monetary developments, capital movements, and the development of the exchange rate. (c) The exchange rates were unified, and this found its main expression in the elimination of the budgetary export incentives and hence a relative decline in the exchange rate for exports compared with that for financial activities.

These changes created a new monetary situation, marked by an elastic supply of foreign currency assets and liabilities to the public, and with the overall monetary expansion (i.e. in both local and foreign currency) being largely determined by demand forces. They gave monetary policy a greater sway over monetary expansion in the Israeli currency segment, but since the relative importance of this segment diminished, the possibility arose of a clash between the monetary policy and balance of payments objectives. Thus a policy of monetary restraint aimed at dampening domestic demands could have led to a larger inflow of short-term capital from abroad, thereby depressing, at least in the short run, the real exchange rate, and detrimentally affecting the profitability of exports (after the unification of exchange rates exports could no longer be stimulated by increasing the incentives). In other words, a situation has arisen where the conduct of a relatively expansionary monetary policy, consistent with the basic balance of payments objectives, necessitates a contractionary fiscal policy.

In the absence of a restrictive fiscal policy, the monetary authorities were confronted in 1978 with a difficult choice: between a policy designed to curb domestic demands but which would harm exports in the short run, and a stimulative policy that would facilitate the achievement of the balance of payments goals in the short run, but at the price of forgoing the contraction of domestic demands. In the early part of the year a relatively expansionary monetary policy was followed, but in view of the development of economic activity and prices the Bank of Israel began to gradually tighten its policy. As a result of this, and owing to the more laggard change of the exchange rate from August onward,³ there was a strong incentive to step up private capital imports in the short run (the weakening of devaluation expectations reduced the anticipated cost of such imports). This gave rise to self-justifying expectations, with the short-term capital imports moderating the increase in the exchange rate, diminishing the anticipated change in the rate, and stimulating the import of additional capital. The Bank of Israel took action to loosen the connection between the movement of the exchange rate and the monetary policy measures which made nondirected foreign currency credit more expensive compared with its price abroad. This enabled the central bank to tighten its policy at the beginning of 1979 with-

³ On the face of it, the more restrictive monetary policy introduced at the time might have been a factor in checking the exchange rate in August by increasing the inflow of short-term capital, but the capital inflow data for that period do not point to such an effect.

TABLE XV-1

GROWTH OF THE PUBLIC'S FINANCIAL ASSET HOLDINGS, 1976-1978
(percentages)

	Balances at end of period			Increase over previous period			
				1977		1978	
	1976	1977	1978	Nominal	Real ^a	Nominal	Real ^a
Short-term assets^b	28	30	31	83	28	69	14
Thereof:							
Money supply	10	8	7	39	-3	45	-2
Foreign currency deposits of Israeli residents (demand and time)	5	7	10	136	66	143	64
Personal restitution deposits	1	14	13	114	50	54	4
Long-term assets^c	72	70	69	66	16	63	10
Securities (direct holdings)	20	18	16	53	7	46	-2
Bonds	14	10	7	13	-21	30	-12
Shares	6	8	9	150	75	65	11
Institutional saving	52	52	53	71	20	69	14
Thereof:							
Approved savings schemes	14	16	16	83	28	73	17
Social insurance funds	28	27	28	64	15	69	14
Total assets	100	100	100	71	20	65	11
Thereof: liquid assets ^a	32	27	26	41	-1	63	10

^a Deflated by the consumer index.

^b Money supply, foreign currency deposits of Israeli residents (demand and time), time deposits, and deposits of personal restitution receipts.

^c Social insurance funds, approved savings schemes, mutual fund assets, life insurance funds, long-term indexed deposits, and direct security holdings.

^d Money supply, foreign currency deposits of Israeli residents (demand and time), bonds held by the public, and time deposits.

SOURCE: Bank of Israel calculations.

out further depressing the real exchange rate. The public anticipated these measures, and within a two-week span greatly stepped up its foreign currency borrowing (by some \$ 250 million).

In addition, the Bank of Israel had to formulate a policy for foreign currency transactions with the public after the floating of the IL. In principle, it was decided that the Bank's direct intervention in the foreign exchange market would be confined to moderating the impact of random short-term destabilizing fluctuations without attempting to influence the direction of the rate in the longer run as determined by basic demand and supply forces. In practice the Bank implemented this policy so as to permit a close connection between the movement of the real exchange rate and the private sector's basic balance of payments deficit.⁴ With the rebounding of domestic economic activity, the private sector's current account deficit deteriorated, while its inflow of long- and medium-term capital expanded. During the first three quarters of the year the Bank of Israel did not reduce its sales of foreign currency to this sector for financing excess payments in connection with its transactions with the foreign sector; in fact, it even increased them a bit.⁵ As a result of this policy, the net effect of the demand for foreign currency assets on the exchange rate was greatly reduced. Subsequently, when the change in the exchange rate relative to the advance of prices slowed appreciably, the Bank of Israel became a net purchaser of foreign currency from the public.⁶

In the absence of perfect substitution between the various categories of assets and liabilities of the public, and in view of the frequent changes in the weights and even in the characteristics of the various aggregates (a phenomenon particularly pronounced in 1978), the dimensions of the monetary-financial expansion cannot be measured by a single datum. Examination of a number of indicators shows that 1978 was a year of monetary-financial expansion. The public's financial asset holdings soared 65 percent during the year, and the value of its liquid assets by 63 percent, compared with a 48 percent rise in the consumer

⁴ Defined as the difference between the sector's deficit on current account and its net import of long- and medium-term capital.

⁵ The private sector's quarterly current account deficit grew from some \$ 300 million in 1977 to about \$ 400 million in the first three quarters of 1978. At the same time the sector's quarterly long- and medium-term capital imports expanded from \$ 230 million, so that the deficit rose by roughly \$ 60 million a quarter. During this period the Bank of Israel increased its quarterly sales of foreign currency to the public for covering its transactions with the foreign sector from \$ 190 million to \$ 225 million, i.e. by less than the growth of the deficit (see Table VI-11).

⁶ Compared with the first three quarters of the year, the basic deficit of the private sector shrank by \$ 220 million in the final quarter; in that period the Bank of Israel purchased \$ 330 million from the public.

price index. The balance of credit provided by the money market for financing domestic activity and exports (other than diamonds) expanded by 74 percent in each case during the year, compared with a 57 percent rise in the price deflator for private resource uses (this too net of diamonds).⁷ Medium- and long-term credit increased 60 percent, as opposed to a rise of some 70 percent in the index of investment prices, so that in real terms such financing sagged, but by less than the growth of short-term credit.

In contrast to the formidable growth of assets and credit, the money base shrank in real terms (it expanded only 30 percent both on an annual average and in December levels). However, considering the relationship between this development and the growth of the foreign currency deposits of Israeli residents, this must be regarded as one aspect of the relative decrease in the Israeli currency segment of the monetary scene but not an indication of overall monetary contraction.

Two important factors stoked demand for financial assets and liabilities this year. First of all, the acceleration of economic activity after a prolonged bout of stagnation was likely to have a multiplier effect on the demand for assets and credit (particularly as the expansion of activity was reflected in investments and in purchases of durable goods, which are financed to a large extent by credit). Secondly, the opening of new channels for assets and credit and the changes that took place in relative yields (such as the widening of the differential between the price of directed export credit and the return on foreign currency assets) might have had a stimulative effect on financial demands. One example of the influence of liberalization on total financial demands was the greater possibility of substitution between foreign currency deposits and stocks of imported goods (whose growth in the past was related *inter alia* to the intensity of devaluation expectations).

Considering these influences, it could be argued that on the face of it the 1978 monetary expansion was not greater than warranted by the increase in activity and the structural changes in the financial markets.⁸ But it must be borne in mind that the expansion this

⁷ In terms of annual averages too there was a real growth of assets and credit, with an especially big increase in that for financing exports. The data presented here actually underestimate the scope of the real expansion of credit supplied by the money market for financing domestic activities and exports, for two reasons: (a) In such credit the share of that for investment purposes is relatively small, while the steep jump in investment prices imparts an upward bias to the price deflator for resource uses. (b) While the much larger volume of credit made available to the diamond industry this year was primarily associated with the higher cost of maintaining inventories, the amount of credit was greater than warranted by the industry's estimated cash flow (part of the excess may have been used to repay credit received directly from abroad).

⁸ Especially considering that the private sector supplied more short-term credit to the government than in 1977.

year followed on the heels of an even larger one last year. All told, in these two years the growth of the monetary variables⁹ reached very sizable dimensions, making it one of the factors fueling demands in 1978, and hence stimulating economic activity and aggravating price inflation.

The underlying causes of the monetary-financial expansion were, as in the past, the cash flows associated with the government's demand surplus, the provision of subsidized credit to the public by the government and the Bank of Israel, and the balance of payments deficit of the private sector. The scope of the monetary-financial expansion is also determined by the public's decisions made in the light of the returns available on the various saving-investment outlets (notably the yields on bonds and long-term savings and the interest rate on nondirected foreign credit).¹⁰

During the year surveyed the public reshuffled its portfolio of financial assets. The most striking change was a big increase in the proportion of Israeli residents' foreign currency accounts (both demand and time deposits). This was partly due to the preference shown by those conducting transactions in foreign currency to hold liquidity in such currency (and at the same time to resort to foreign currency financing). In addition, the characteristics of the foreign currency accounts attracted the public, which regards them as a store of value for short and medium periods, and apparently even for long periods. Along with the greater use of such deposits as a substitute for money, there was a further real decrease in the money supply and in other types of unlinked near money in Israeli currency. The hectic rise in share market trade and prices in 1977 was not repeated this year, and in the second half the market even retreated with the acceleration of inflation and the floating of large issues by the banking concerns. During the year, and particularly in the second half, there was a diminished tendency for the public to pull out of the bond market, owing to the Bank of Israel's campaign to encourage the purchase of such paper which was mounted in the light of the large volume of bonds scheduled to be redeemed toward the end of 1978, the movement of the exchange rate and prices during the year, and perhaps also the small real yield differential between bonds and long-term assets. Finally, after a sharp rise in 1978, there was a slower accumulation in the long-term institutional saving instruments offered by the capital market. In general, it can be said that

⁹ See Tables XVI-1 and XVI-2. In Table XVI-2 the long-term credit data refer to annual averages; hence there is no contradiction between the accelerated growth of these averages in 1978 and the more sluggish real increase in such credit during the year.

¹⁰ A detailed analysis of the sources of the monetary-financial expansion and the influence of the rates of return on the magnitude of the expansion necessitates a conceptual framework which is not yet available to us. Parts of such a framework may be found in Table XI-3, in the discussion of the money base in Chapter XVII, and the discussion of the government's operations in Chapter XVIII.

TABLE XVI-2

GROWTH OF CREDIT, 1976-1978
(percentages)

	1976	1977	1978	Increase over previous year			
				1977		1978	
				Nominal	Real	Nominal	Real
Annual average balances							
Short-term bank credit							
For domestic activity	67	64	56	44	5 ^a	74	10 ^a
Thereof: Nondirect credit in foreign currency	22	23	24	60	16 ^a	105	29 ^a
For exports (excl. diamonds)	22	22	24	52	4 ^b	110	35 ^b
Total, excl. diamonds	89	86	80	46	5^c	83	15^c
Diamonds	11	14	20	102	13 ^d	182	23 ^d
Total	100	100	100	52	7^e	97	21^e
Credit flow during the year							
Medium- and long-term credit							
From capital market financial institutions	..	75	71	..	..	50	-12 ^f
From the government, other than through capital market financial institutions	..	14	15	..	..	79	5 ^f
From earmarked foreign currency bank deposits	..	11	14	..	..	100	17 ^f
Total		100	100	..	..	60	-6^f

^a Deflated by the implicit price index for private domestic uses.

^b Deflated by the index of effective nondiamond export prices.

^c Deflated by the implicit price index for domestic private uses and the index of commodity and service export prices excl. diamonds (calculated at the effective rates of exchange).

^d Deflated by the index of effective diamond export prices.

^e Deflated by the implicit price index for domestic uses net of private consumption.

^f Deflated by the index of investment prices.

SOURCE: Short-term bank credit - Table XVII-5; medium- and long-term credit and price computations - Bank of Israel calculations.

there was a relative decline in 1978 in the weight of assets in the extremes of the liquidity range, with a tendency to increase the liquidity of those regarded as semiliquid.¹¹

The most prominent developments in the composition of credit this year were the strong growth of nondirected and directed credit in foreign currency and the real decline in medium- and long-term credit. During the year there was a relative shift away from nondirected local currency credit, due largely to the bulging of Israeli residents' foreign currency deposits, which reduced the flow of local currency resources to the banking sector.¹²

Directed foreign currency credit for exports rose proportionally more than export production. This was connected with the widening of the differential between the interest rate on such credit and the alternative returns in foreign currency, and in general with factors encouraging the resort to nondirected foreign currency credit, for it is impossible to prevent firms operating in both the home and foreign markets from using export credits to finance domestic operations as long as they do not exceed their permitted export credits.¹³ In contrast to the rapid expansion of export credit in foreign currency, the policy was continued of reducing directed IL credit for export and domestic production-credit whose subsidy element increased in the last few years because of the lagged adjustment of interest rates to the advance of prices.

The real decrease in long- and medium-term credit this year despite the checking of the real contraction of investment is explained primarily by the fact that the receipt of credit for this purpose lags behind the implementation of investment projects, and by

¹¹ In particular, there was an increase in the liquidity of foreign currency deposits, a rise (until the final part of the year) in the proportion of bonds approaching maturity, and in general an increase in the liquidity of bonds. There was also a switch from time deposits to negotiable deposit certificates, which are more liquid. It is hard to estimate the liquidity of the various types of assets, since "liquidity" consists of a number of elements which apply in a dissimilar and changing degree to the different categories of assets.

¹² The contractionary effect of the favoring of foreign currency deposits on the Israeli currency segment was reduced somewhat by the large share issues floated by commercial banks.

¹³ In spite of this phenomenon, there was no reduction in the rate of export financing, nor was the interest rate raised on directed foreign currency credit (apart from a partial adjustment toward the end of the year of the rate on credit extended to the diamond industry). In this way exporters were compensated to some extent (although not necessarily in an efficient manner) for the other factors that affected the profitability of overseas sales.

the especially steep jump in investment prices, which, as stated, was not reflected in the volume of such financing. This may have induced a heavier recourse to the money market for the interim financing of investments, and is expected to lead to a heftier expansion of long- and medium-term credit next year. In 1978 the already small share of the system of capital market institutions in the provision of long- and medium-term credit declined, while the proportion of financing supplied directly by the government and the commercial banks from their lines of foreign credit (most of which carries exchange rate insurance) rose. It seems that the government has more of a say in the direction of the last-mentioned types of credit, but the dispersion of long-term credit among more channels is likely to result in a diminished coordination of such financing.

Together with the enactment of a new capital investment law, in August a more flexible framework was introduced for determining the interest rate on long-term investments in industry and tourism and for its partial adjustment to the inflationary conditions. In addition, the period of the loans was extended, and in sum there was apparently no change in the subsidy element of such investments. However, the change in the maturity of the loans will affect the amount of funds mobilized by the system of capital market institutions through repayments (which in 1978 accounted for about half of their total sources of funds).