CHAPTER XV

MAIN DEVELOPMENTS IN THE MONEY AND CAPITAL MARKETS

In 1979 a policy of restraint was followed in both the money and the capital market. Short- and long-term credit was made more expensive and quantitative restrictions placed thereon. The dearer cost of capital dampened demands and business activity, although this was not evident in most months of the year, finding expression mainly in the final part of 1979 and particularly in the first quarter of 1980. The policy also created an interest rate differential between assets and liabilities, which was an important factor in the disparate development of financial assets and liabilities in the public's portfolio.

The blunting of monetary expansion in 1979 came after two years of rapid growth, which was due primarily to a sizable public sector liquidity injection and the provision of directed export credit, to which was added from the middle of 1978 a large inflow of foreign capital following the easing of foreign currency control. Liberalization has confronted the economy in general and the monetary sector in particular with new problems which necessitate the conduct of a monetary policy giving special heed to its impact on the exchange rate. Under such conditions the aim of cooling inflation through monetary restraint clashes, at least in the short run, with the balance of payments goals, for such a monetary policy results in a larger capital import, thereby slowing the real devaluation of the Israeli pound and expanding the total supply of liquidity. It follows that the principal way to harness domestic demands without harming the balance of payments is a stringent fiscal policy. In the absence of such a policy the Bank of Israel preferred, in the second half of 1978, to curb the domestic monetary segment. In addition, devaluation expectations waned, creating a differential between the domestic interest rate and the rates abroad. This sparked a substantial capital import and kept the exchange rate from adjusting to the mounting level of inflation. The capital influx was especially large in December 1978 owing to fears of a possible curtailing of liberalization.

It was mainly these developments that prompted the Bank of Israel to decide in April 1979 to rein back the monetary expansion by hiking the interest rate by 12 percentage points on nondirected foreign currency credit and to quantitatively

Table XV-1

GROWTH OF CREDIT, 1977-79
(Percentages)

	Short-term bank credit, excluding fuel						
	Distribution of end-year balance			Increase in average balance			
				Nominal		Real	
	1977	1978	1979	1978	1979	1978	1979
Credit to the domestic market	53.5	53.6	47.9	84	83	22	2
Directed export credit	46.5	46.4	52.1	124	90	49	6
Total	**100.0**	**100.0**	**100.0**	**101**	**86**	**33**	**4**
In Israeli currency	50.0	43.6	29.8	51	44	1	-19
In foreign currency	50.0	56.4	70.2	169	118	79	22

	Medium- and long-term credit						
				Increase in flows			
	Distribution of flows			Nominal		Real	
	1977	1978	1979	1978	1979	1978	1979
Productive sectors	64.8	64.6	62.0	60	77	-6	4
Households	23.7	23.3	24.6	58	92	-6	-9
Local authorities and National Institutions	11.5	12.1	13.4	68	103	1	6
Total	**100.0**	**100.0**	**100.0**	**61**	**83**	**-5**	**1**

Source: Short-term bank credit — Table XVI-A5.
Medium- and long-term credit — Tables XVII-3 and XVII-4.

limit nondirected credit in both Israeli and foreign currency. This reduced the supply of liquidity from foreign sources and weakened the connection between the movement of the exchange rate and domestic monetary developments. These steps helped to make short-term nondirected credit dearer and greatly reduced the inflow of short-term capital from the second quarter of 1979 onward, a trend which continued, with some fluctuations, until the end of the year.[1]

The rapid monetary expansion of the two preceding years left the economy with a large reservoir of liquidity at the beginning of 1979. During the year it dwindled in real terms, partly because of the shrinkage of the sources of growth and mainly because the escalating inflation ate into the excess liquidity. The contraction of the

[1] The reference here is to the import of short-term capital as derived from the private sector's basic balance of payments deficit and its net purchases of foreign currency from the Bank of Israel. The estimate does not accord with the actual data, which point to a more modest downtrend in capital imports (for more details see Chapters III, VI, and XVI).

sources of growth occurred only in the first half of the year, and is explained by three factors: the draining out of some IL1 billion through public sector operations (see Table XVI-1),[2] the curbing of short-term capital imports beginning in the second quarter, and a greatly increased absorption through the balance of payments following the rise in world fuel prices. In the second half of 1979 there was a sharp reversal of trend—from an absorption to a sizable injection by the government. This could have resulted in an exceptional monetary expansion were it not for the mopping up of liquidity through the private sector's balance of payments because of a further jump in fuel prices. It can be said that the expanded domestic supply of liquidity by the government permitted the financing of a much larger balance of payments deficit on current account this year, and moderated the impact of the rise in world fuel prices on economic activity in general and private consumption in particular.

The greatly increased government injection in the second half of the year reflected contrasting developments on the receipts and payments sides. On the one hand there was a nominal decline in the amount of credit granted to the government by the public and the banking system and a real decrease in total tax receipts. On the other hand government payments rose precipitately in real terms. Examination of the government's operations shows that the source of the incremental injection lay in its fiscal and financial activities alike. The excess of the public sector's payments over receipts shot up by some IL20 billion in the second half of the year, with over half the sum (about IL12 billion) deriving from the government's financial activities—the result of both a drop in the public's savings and an increase in medium- and long-term credit provided to households and to the productive sectors of the economy (see Chapter XVII).

The much larger amount of money put into the economy in the second half of 1979 partly reflected the response of market forces to the credit squeeze. It is reasonable to assume that the appreciable hiking of the interest rate on credit was a decisive factor in the reduced capital mobilization from the public. The creation of a significant differential between the interest on credit and that on assets induced the public to shed part of its asset holdings which constituted a substitute for credit. The dearer price of credit and its quantitative restriction apparently also led to a decline in supplier credit to the government and the deferment and even reduction of tax payments. It will thus be seen that a stringent monetary policy unaccompanied by the reduction of the government's demand surplus is of limited efficacy.

[2] The basic injection includes the net mobilization of capital through the sale of bonds to the public. Excluding this item, the amount of money pumped out of the economy in the first half of the year was IL3 billion.

Uncertainty about how the public sector's injection would develop and the sizable liquidity deficiencies incurred by the banks, which were the sources of the swelling of credit in the two preceding years, prompted the Bank of Israel to make the expansion of Israeli currency credit so expensive to the banks that they would refrain from deviating from established policy. Beginning in April the banks were given a low-interest loan to cover their liquid asset shortfalls. In exchange they undertook to freeze foreign currency credit (in dollar terms) and to limit the growth of Israeli currency credit to a rate ranging between 0 and 4 percent a month. Since overstepping the limit resulted in the reduction of the loan, the banks were deterred from exceeding the limits set and in most months of the year they resorted to the allocation of Israeli currency credit. This policy was further tightened in November when the ceiling was lowered still more.

The upping of the interest rate on foreign currency credit and the dearer cost of expanding Israeli currency credit significantly increased the real interest, particularly on foreign currency credit. It is hard to clearly trace the development of the public's devaluation and inflationary expectations, but if we assume that it did not anticipate a real devaluation, the real interest on foreign currency credit moved up from about 2 percent at the beginning of the year to about 14 percent in April.[3] The rate on Israeli currency credit also rose, but at the end of the year was still below that on foreign currency credit. Nevertheless, the weight of the latter increased, evidence that its price constituted the marginal price of credit in the economy.

Credit policy concentrated on curbing nondirected credit (excluding fuel); during the year it expanded by 71 percent, far below the 111 percent rise in the consumer price index. At the same time, the amount of export finance continued to grow strongly, in line with the trend of the past few years. The increase in total bank credit (excluding fuel) came to 102 percent (see Table XVI-8). The policy was tightened after bank credit had been greatly stepped up last year; the annual average real growth of such finance (excluding fuel) was about 4 percent (see Table XV-1), compared with an 8 percent real rise in domestic resource use (excluding direct defense imports).

The terms of medium- and long-term directed credit also underwent significant changes this year. Until 1979 the interest charged on the bulk of such finance, which is provided in accordance with government directives, lagged far behind the rate of inflation. The marked aggravation of inflation increased the subsidy component of long-term finance, and so the government decided in May 1979 to drastically revise the credit terms, as follows:

[3] Other indicators of the public's expectations also point to a rise in the real interest on short-term credit. For more details see Chapter XVI, section 2 (d) and Table XVI-5.

(a) Loans to the productive sectors of the economy will henceforth be fully indexed and carry an extra 0.5-1.5 percent interest; alternatively, they will be linked to the dollar with an extra 6-7 percent interest charge.

(b) In the case of requests already in the pipeline the loans will be linked 70 percent to the consumer price index, with the extra interest ranging from 0.5 to 2.5 percent; alternatively, they will be fully linked to the dollar, with a similar extra interest charge.

(c) The bulk of housing credit in the development areas will be only partly linked to the consumer price index; elsewhere most of the credit will be fully linked, with interest ranging between 0 and 5 percent. Although the terms have been stiffened, a larger volume of such finance will be made available, the repayment period has been extended from about 12 years at the most to 20 years, and the initial repayment burden has been eased.

The impact of these changes will probably be felt in most sectors of the economy mainly in the coming year, whereas in the housing industry it will already be felt this year. This can be attributed to two factors: first, a large part of the credit received this year by the productive sectors was given at the previous terms; secondly, under present conditions the tax laws increase the subsidy element enjoyed by part of the companies in the economy (for more details see Chapter XVII).

The other determinant of long-term credit policy is the total supply of credit. In view of the existence of fixed criteria for the provision of such finance, its volume is a function of demand; but it should be noted that, besides the amount granted in accordance with these statutory criteria, investors and home buyers are given "supplementary credit", which actually serves to regulate the volume of credit. This year supplementary credit was almost totally abolished, which attests to the adoption of a policy of government rationing, in addition to the revision of credit terms. As a result, total long- and medium-term credit held steady in real terms, after it had decreased in 1978. Thus, for the second consecutive year, the growth of credit lagged behind the growth of investment. This reflected contrasting trends in the financing of the various sectors of the economy: the amount supplied for industrial investment and the purchase of homes fell off in real terms, while credit to the service sectors was higher this year.

The direct increase of real interest on short-term credit, the stiffening of the terms of industrial and housing credit, and the limitations placed on the growth of all types of credit in the economy caused many firms to experience considerable financing difficulties, especially in the case of investments. The simultaneous restriction of long-term directed credit and of short-term nondirected credit forced companies to rely more heavily on equity capital, which under the existing tax arrangements is much costlier than credit. This, together with various other factors (see Chapter II), dampened demand for goods and services, which in turn led to the slowing of economic activity in the first half of 1979 and even more so in the final quarter of 1979 and the first quarter of 1980. The ebbing of demands was reflected by a drop in private consumption and investment in the final quarter of 1979, while the uptrend in public consumption and exports continued unabated. This is explained by the fact that the main thrust of economic policy was designed to leash domestic uses of the private sector, while government demand continued to grow and export incentives were increased. The availability of export credit was not affected at all; what is more, the escalation of inflation and the exemption of such credit from the interest surcharge increased the subsidy element in directed export credit. This policy discriminated in favor of exports while creating marked distortions, the most important being the uneven subsidization of export value added in the various sectors and the narrowing of the scope within which monetary policy can operate effectively because of the dependence of the liquidity injections on the growth of exports (see also Chapter V in this Report).

The effectiveness at the end of year of the restraining measures can be ascribed to the lagged effect of the interest rate hikes on domestic demands and to the relatively long gestation period of investments. It is reasonable to assume that the bulk of the investments in 1979 were made before the revision of monetary policy in the money and capital markets; the influence of the change will therefore be felt primarily in the coming year. Evidence of this may be found in the data on residential and non-residential building starts, which began to turn down in the second quarter of 1979 and by the final quarter stood far below their level at the beginning of the year. Another factor which might further depress investment is the expected reform of the tax laws after submission of the report of the committee set up to study taxation policy under inflationary conditions. If the committee's recommendations are accepted and implemented, the long-term credit subsidy in the form of recognition of linkage differentials as a deductible expense for tax purposes will be abolished, and the credit terms will be further tightened.

Despite the stringent credit policy, inflation grew much worse in 1979. In the first quarter of 1980 it slowed down, but in view of the steep rise of prices in April 1980 it is still too early to say whether there has actually been a change of trend. This poses the question whether a policy of monetary restraint which focuses on making the various types of credit more expensive is capable, in the absence of a restrictive fiscal policy, of cooling the inflationary process. The upping of the price of credit was accompanied by a sharp rise in the public sector's liquidity injection, which began in August 1979 and is still going on. This was primarily due to an increase in government payments, but to some extent it also stemmed from the squeeze on credit to the private sector, which caused it to reduce its credit and tax payments to the government. This combination of monetary restraint and the continued operation of the inflationary forces (such as the growth of government spending, abolition of commodity subsidies, and the rise in fuel prices and wage costs) is liable to dampen economic activity without slowing inflation.

The policy followed this year has important implications for the economy's growth potential. On the one hand the value-linking of development loans has resulted in a more efficient allocation of the available resources and may help to diminish the government's intervention in the capital market. On the other hand the real interest rate on short-term credit was raised to about 15 percent before tax; this is an exceptionally high rate, which far exceeds that generally found in developed economies. Persistence with such a rate for any length of time is liable to deter investments worthwhile to the economy and to its growth, since a rather substantial share of nondwelling investment is financed through short-term nondirected credit and equity capital. The problem of economic growth and the countervailing influence on the government liquidity injection of a policy based only on the curtailing of credit points up the shortcoming of attempting to restrain credit solely by making it more expensive. What is called for is a monetary policy whose main plank is the reduction of the government's demand surplus and the liquidity injection generated thereby.

The policy measures introduced this year also affected the public's net wealth and its composition. For lack of data on the present value of unlinked credit, we shall not discuss the public's total assets and liabilities but shall confine ourselves to financial assets. These declined this year by about 4 percent in real terms (see Table XV-2), while the stock of consumer durable goods and fixed assets expanded greatly. The much heavier purchase of durables may have represented a compensatory adjustment to the strong upsurge in 1977-78 in financial assets compared with durables (rises of 35 and 14 percent respectively). That the increased consumption of durables took place this year is probably explained by the introduction of a new product on the market—color television—and by the decline in the relative price of imported durables at the end of 1978 because of a real upvaluation of the Israeli pound. The larger fixed investment this year reflected different trends in home purchases and nondwelling investment, and in the main was an outcome of the renewal of economic growth in 1978 and the expectation that it would gather momentum in 1979.

The contraction of the public's financial assets in 1979 was undoubtedly connected with the change in the ratio between its financial and physical wealth, but to a large extent it was also due to the change in the interest rate differential between liabilities and financial assets. The rationing of long- and short-term credit and the direct increase in the price of the latter at a time when the return on assets rose only fractionally prompted the public to shed part of its assets as a relatively cheap

Table XV-2

FINANCIAL ASSETS OF THE PUBLIC, 1976-79
(Percentages)

	Composition of portfolio at end of period				Real increase	
	1976	1977	1978	1979	1978	1979
Liquid financial assets	37	32	30	27	7.6	-13.7
Unlinked	12	10	8	5	-6.5	38.1
Patam[a]	5	7	10	11	61.0	7.3
Bonds	20	15	12	11	-8.3	-14.4
Medium-term financial assets	33	40	40	40	12.7	-2.6
Shares	8	11	11	9	15.0	-18.0
Restitution deposits	11	13	13	12	3.8	-6.0
Savings schemes and value-linked deposits	14	16	16	19	18.8	10.4
Long-term financial assets						
Social insurance funds and life insurance	30	29	30	32	14.3	5.8
Total financial assets	**100**	**100**	**100**	**100**	**11.5**	**-3.5**
Linked to foreign exchange	18	22	25	25	20.5	-1.5
Linked to consumer price index	62	57	56	60	10.5	3.6
Other	20	21	19	15	4.7	-26.5

[a] Local residents' foreign currency deposits.
Source: Table XVI-6 and XVIII-14.

substitute for credit. It is natural for such an adjustment process to be reflected primarily in the reduction of liquid assets; but the downturn was particularly sharp (14 percent in real terms), while long-term assets and savings schemes continued to grow at a relatively high rate. A change in the value of any asset in the public's portfolio is influenced both by its accumulation and by a change in its relative price. It should be noted that the decline in liquid assets in 1979 also stemmed from a sharp drop at the end of the year in the market price of bonds held by the public. This did not affect the value of savings schemes and social insurance funds, since they are revalued according to the rise in the consumer price index.[4] These assets also expanded because of their further relatively rapid accumulation, which can be credited to two factors. First of all, household saving in social insurance funds continued upward because of the existing institutional arrangements: the steep real wage and salary hikes directely increased employee contributions to pension schemes, while the wage agreements concluded enlarged the population saving in the form of pension and advanced study schemes and increased employers' contributions to severance pay and advanced study schemes. Voluntary contributions

[4] This is justified by the long investment horizon of savings schemes and social insurance funds, which ranges between three and 15 years. Hence short-term fluctuations in bond market prices do not play much of a role in the public's evaluation of these assets.

to provident schemes, in the main made by self-employed, declined this year despite an improvement in the return, including tax concessions; this also attests to the influence of the credit squeeze. Secondly, savings scheme deposits continued on a high level, in line with the previous year's trend, owing to the more attractive return on the new schemes and the larger grants offered this year by banks in their numerous advertising campaigns to plug these schemes. There was also a larger investment in 1979 in linked time deposits (which offer a higher yield than bonds), since the minimum deposit in such accounts was not adjusted for the change in prices in the economy.

The decrease in liquid assets was accompanied by a significant change in their composition: the money supply, time deposits in Israeli currency, and bonds fell off sharply, while the weight of Patam local resident foreign currency deposits continued upward. The declining weight of unlinked assets began in 1973 with the onset of rapid inflation. It grew more pronounced in the last two years because of the marked aggravation of inflation and the introduction of Patam accounts with the liberalization of foreign currency control. The possibility of investing in Patam, which is linked to the exchange rate but is more liquid than bonds, also affected the weight of the public's direct bonds holdings: these shrank from 20 percent at the end of 1976 to 12 percent at the end of 1978. Various signs indicate that the switch from bonds to Patam in the wake of the liberalization had run its course by the end of 1978. To be sure, the weight of Patam rose a notch in 1979 too, but this occurred in the final quarter of the year and was due primarily to the fear that the foreign currency liberalization would be curtailed and to anxieties about the possible imposition of a capital gains tax on bond linkage increments. This led to a net bond redemption of some IL6.5 billion in the final quarter of the year and the expansion of Patam by a similar amount (see Table XVI-1). The waning of the public's confidence in bonds also stemmed from its belief that the exchange rate would be more stable because of the movement of bond prices in the secondary market; this was reflected by an increase in the relative variance of bond yields and a parallel decline in that of Patam (see Table XVII-4). Further evidence that the public was expecting some deliberalization can be found in the sale of foreign currency to the public in this quarter, which far eclipsed the basic balance of payments deficit of the private sector. Various indicators show that a substantial percentage of the sale consisted of foreign banknotes.

Analysis of the public's portfolio by type of asset shows that the weight of assets linked to foreign currency hardly changed this year, while that of assets linked to the consumer price index moved up about 4 percent. This increase reflected the expansion of social insurance funds and savings schemes, which was due not only to the wage agreements and the more attractive terms offered, but also because these components are generally less subject to speculative fluctuations. The public apparently believes that even if bonds are impaired, institutional saving will prove less vulnerable.

A longer-range look shows that the chief effect of liberalization was to increase the foreign currency component in the public's liquid asset holdings, at the expense of both money balances and bonds, while most of the long-term saving continued to be made, as in the past, in indexed assets, since in the long run assets linked to the consumer price index give a higher real yield and involve a smaller risk than assets linked to foreign currency. To sum up, the weight of indexed assets in the financial assets portfolio has hardly changed since 1976, while those linked to foreign currency have occupied the place held by unlinked assets.

The expansion of linked assets has been accompanied by the contraction of unlinked assets and shares. This year demand for equities subsided, largely because the bulging supply of shares last year sharply depressed their real yields (for details see Chapter XVIII).

The changes in the public's financial assets portfolio also affected the capital market resources available for investment credit. This year the public's asset accumulation continued to fall off in real terms, by 7 percent, and there was a similar decrease in loan repayments. Nevertheless the real level of long-term credit provided by the capital market was maintained, thanks to the increase in such additional sources as the government, foreign sector, and Bank of Israel, which bridged the gap, and also to the decrease in the capital market's uses of funds and in transfers to the commercial banking system.