

## CHAPTER XVII

### MAIN DEVELOPMENTS IN THE MONEY AND CAPITAL MARKETS

In 1977 there were three outstanding developments in the monetary sphere. First, the rate of monetary expansion accelerated strongly, as reflected in the volume of bank credit to the public and the money supply, where the annual average increase eclipsed that in the level of economic activity. Secondly, the public's demand for financial assets underwent a significant structural change, as indicated by the impressive real growth of long-term institutional financial savings and an unprecedented share market boom. In contrast to this the general public shed a substantial part of its direct bond holdings. Thirdly, a foreign currency reform was introduced in October, and while it had not yet made its full impact felt by year's end, it marked out the course of future developments.

The changes in the composition of the public's demands, coupled with the greatly changed distribution of private saving between households and business,<sup>1</sup> contributed directly and indirectly to the livelier demand for money and credit, which expanded by more than required for financing the modest level of economic activity in 1977.

The rapid monetary expansion was mainly made possible by the continued increase in the public sector's liquidity injection, with no offsetting increase in the amount siphoned off through private sector purchases of foreign currency. Another factor which helped to fuel the monetary expansion was the channeling of a relatively large percentage of the capital market resources to financing the operations of the banking industry, which accounted for the bulk of the new share issues to the general public.

This development was also reflected in a very sizable expansion of the financial resources of the system of capital market institutions. Because of the smaller domestic investment this year, the amount of financing provided by the system in accordance with the public sector directives declined, with the result that the excess of the system's resources over their uses in the capital market grew. The lion's share of this surplus was transferred to the government.

The year reviewed was characterized, as stated, by a faster monetary expansion in most months. This was clearly manifested in the development of the various types of bank credit to the public and the money supply. But the expansion did not proceed at an even pace, there being two distinct subperiods: until the October reform and the sub-

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<sup>1</sup> Business saving continued to sag in 1977, while household saving turned upward after the previous year's drastic decline.

TABLE XVII-1  
SELECTED INDICATORS OF THE MONEY MARKET, 1976 AND 1977

	1976				1977			
	Increase or (-) decrease				Increase or (-) decrease			
	During the year	Annual average	During the year	Annual average	January- 26 October	26 October- December	During the year	Annual average
	(IL million)	(percent)	(IL million)		(percent)			
Changes in broad money base and in liquidity deficiencies	2,250	22	14	5,487 <sup>a</sup>	44	41	31	10
Change in narrow money base	3,388	39	16	5,209	44	43	31	9
Injection from the public sector	8,142	..	..	11,098	..	..	11,148 <sup>d</sup>	-50 <sup>d</sup>
Absorption through payment balance of private sector <sup>d</sup>	-5,749	..	..	-5,572	..	..	-6,811	1,239 <sup>d</sup>
(Outstanding balances at the end of the period)								
Money supply	13,486	27	18	18,717	39	41	31	6
Non directed credit	8,958 <sup>c</sup>	24 <sup>c</sup>	30 <sup>c</sup>	13,268	48	39	39	6
Directed credit	11,119	40	36	21,945	97	62	40	41
Thereof: for export	(8,542)	(47)	(45)	(18,577)	(117)	(75)	(48)	(46)
Total credit	20,077 <sup>c</sup>	32 <sup>c</sup>	33 <sup>c</sup>	35,213	75	51	29	36

<sup>a</sup> See Note a in Table XVIII-1.

<sup>b</sup> Excluding the transfer of export shipments financing from credit lines of banks abroad (See Note d in Table XVIII-iv).

<sup>c</sup> In September 1976 credit to the local authorities totalling IL 220 million was transferred from the category of government credit to that of nondirected IL credit to the public. This credit is included in the annual data, but not in the calculation of the percent change.

<sup>d</sup> IL million.

sequent months. Between January and October the money supply went up 31 percent and the public's real balances by about 5 percent. Nondirected credit was stepped up 39 percent during this period, and directed credit by 40 percent (including the revaluation of outstanding foreign currency credit). These rates surpassed the rise in the price indexes during this period: about 25 percent in consumer prices and 33 and 28 percent<sup>2</sup> in the implicit deflators of GNP and resource uses respectively. At the end of 1977, i.e. in the postreform period, the uptrend in the money supply and nondirected credit<sup>3</sup> slackened noticeably, but not to such an extent as to offset their growth in the first subperiod; the annual average rate of increase of the major monetary variables (bank credit to the public and the money supply) exceeded the rate of growth of economic activity (as measured from nominal data on GNP and total uses). This rapid monetary expansion, which has persisted since the final months of 1976, occurred against the backdrop of a moderate level of domestic economic activity<sup>4</sup> and a high rate of inflation.

The much more buoyant demand for money during 1977 was apparently influenced to a large degree by the following factors :

(a) An impressive increase in demand and turnover in the share market. The opening demand in this market far exceeded the actual trade during the year; this attests to a large volume of speculative transactions, which in turn stimulated demand for money and credit. Added to this was the effect of the banking institutions' "value date" method of recording cash transactions, which results in a lag between the date of crediting the customer's demand account for the proceeds from the sale of his shares and the date the sum is actually placed at his disposal. The lack of data makes it hard to determine how much this factor influenced the development of the money supply (and credit).

(b) The significant growth in 1977 of the illiquid components of the public's asset portfolio and those with a relatively high risk element almost certainly augmented demand for money. In this connection mention should be made of the steep rise during the year in the weight of shares in the portfolio; another striking development was the in-

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<sup>2</sup> These data relate to the rise in the implicit price deflators of GNP and resource uses between the fourth quarter of 1976 and the third quarter of 1977 (a period of nine months):

<sup>3</sup> On the implications of this development see the discussion of monetary developments after the reform.

<sup>4</sup> An estimate of GNP by sectoral origin shows a quite mild increase in the business sector product (as in the two preceding years), while a measure according to resource uses points to continued stagnation.

TABLE XVII-2

## SELECTED INDICATORS OF THE CAPITAL MARKET, 1976 AND 1977

	1976		1977	
	(IL million)	Year-to-year change (percent)	(IL million)	Year-to-year change (percent)
A. Main components of household financial savings through the Capital Market intermediaries surveyed in Chapter XIX				
Social insurance funds	2,160	25	3,850	78
Approved saving schemes	2,460	12	5,730	133
Mutual funds	1,340	-20	1,510	13
Life insurance	620	38	910	47
Net securities transactions	-780		-1,810	
Total	5,800	7	10,190	76
B. Net issue of government bonds	-630		-2,030	
C. Issue of shares (and securities convertible to shares)	754	-5	3,990	429
D. Gross medium- and long-term credit through the Capital Market intermediaries surveyed Chapter XIX				
Mortgage loans to households	2,110	13	2,380	13
Credit to industry	2,510	52	3,700	47
Credit to agriculture	890	41	1,150	29
Other credit	3,740	41	5,750	54
Total of all medium- and long-term credit	9,250	36	12,980	40

creased risk associated with direct holdings of bonds by the general public (see the discussion in Chapter XX). Added to these was the swelling of long-term institutional financial saving, which is highly illiquid.

(c) Another factor that affected demand for money during 1977 was the variations in inflationary expectations. At the beginning of the year the public anticipated a slowing of the price advance; these expectations probably reduced the cost of holding money, thereby enhancing demand for it. The monetary developments did in fact reflect these expectations: in the early months the public's real balances swelled appreciably; in the middle of the year, with the mounting of inflationary expectations, they plateaued; and in the final months they fell steeply with the intensification of inflationary expectations.

In credit too there were special demand factors at work, which probably explain developments here; a relatively substantial real expansion of total bank credit to the public and in most months of the year a higher real rate of interest than in the previous year, which did not stem from any appreciable growth in the level of economic activity. Examination of the movement of the real rate of interest shows a fluctuating pattern during the year. In the early months, until the elections, the expectation that inflation would slow noticeably caused the rate of real interest to rise sharply. Around mid-year, with the intensification of inflationary expectations (and apparently because of the monetary measures adopted — see below), the basic rate of interest on nondirected credit was hiked about 3 percentage points (the effective rate went up more because of additional charges). These two factors combined to depress the real rate of interest a little below its level in the first half of the year, although it was probably still higher than in most months of 1976. As for directed credit, there was a precipitous rise during 1977 in the nominal rate on such credit granted in IL for financing domestic activity, and the weight of directed foreign currency credit (which is more expensive) in total directed credit to the public rose. Nevertheless, because of the fluctuations in the public's devaluation expectations before and after the elections, the real interest rate on directed foreign currency credit apparently decreased in the first half of the year, but shot up in the second half because of jitters over the possible introduction of new policy measures.

Despite the protracted stagnation of economic activity, a number of special demand factors led to the growth of bank credit to the public (in real terms), and in most months of the year the real rate of interest was higher than in the previous year. The principal factor was the aggravation of the financing difficulties faced by firms producing chiefly for the domestic market. The continued flagging of domestic demands led to a fairly protracted narrowing of the firms' profit margins, as evidenced by the reduction in 1977 as well of the share of business saving in financing current economic activity. Another factor was the hectic share market boom, which almost certainly contributed to the

heavier demand for credit and the rise in its price, in the hope of earning a quick, handsome profit. A factor of another sort, but also speculative in nature, was a large stockpiling during 1977 of rough diamonds, which presumably was partly financed by borrowing from banks. This was not connected with current domestic economic developments.

To sum up, the accelerated monetary expansion in 1977 was reflected primarily in the financial activity of the general public and the reshuffling of its asset portfolio, and only to a minor degree in economic development and the escalation of inflation. This conclusion can be drawn in view of the moderate level of economic activity and the flagging of domestic demands, as well as in the mounting demand for money (which was greater than required for financing economic activity) and the greater resort in most months of the year to credit despite the relative rise in the real rate of interest. Nevertheless, the monetary expansion probably contributed in the latter part of the year to the revival of demand for housing and the rebounding of residential home construction.

This evaluation of the comparatively small role played in 1977 by the monetary expansion in stimulating domestic demands and in the sharpening of inflation does not detract from the gravity of, and the dangers inherent in, the substantial increase in the public's liquidity this year. The picture becomes even more disquieting after analyzing the demand and supply forces that aggravated the monetary expansion, as well as the share of the public sector in generating these forces.

This refers first and foremost to the huge public sector liquidity injection in the first ten months of 1977, which was mainly due to the steep (65 percent) jump in the sector's wage bill following the signing of retroactive agreements. Fortunately, most of the sizable incremental income was not spent on consumption, but went to expand household saving, after its sharp drop the year before. However, it should be noted that during 1977 direct holdings of bonds by the general public continued to lose their attraction, partly because of the various announcements made concerning the future of this market. This was a major reason for the reshuffling of the public's financial asset portfolio and the heftier demand for money. Conceivably, a resolute policy of encouraging saving, by offering saving instruments in the form of semiliquid financial assets (such as the aforementioned bonds) might have diverted the monetary expansion to more desirable channels. Such semiliquid financial savings would have satisfied the livelier demand for liquidity; at the same time, if circumstances should change and the public's liquidity preference diminish, these assets could not be realized by the public as a whole, and their liquidity would decline with the ebbing of its liquidity preference.

As stated, one of the changes in the composition of the public's demand this year was

reflected in the strongly bullish trend of the share market: equity prices shot up and an impressive volume of new issues was placed with the general public. This was a positive development, and it helped to diminish the government's intervention in the capital market and subject it more to the free play of demand and supply. Withal, this boom reflected two negative factors:

(a) The flourishing of this market was largely fed by the abundant liquidity in the economy, with all its *negative implications*. Since this liquidity situation cannot go on indefinitely, it is bound to affect the market's stamina.

(b) Most of the new issues were floated by commercial banks for expanding their loanable funds; the proportion floated by industrial firms for financing capital expenditures was negligible.

A noteworthy favorable development this year was the change in the public sector's subsidization of investment finance. The cumulative rise in the interest rate on directed credit in recent years has reduced the subsidy element thereof (see details in Chapter XIX). However, it seems that there was a further increase this year in the percentage of agricultural and industrial investment financed in this manner.

Monetary policy in 1977 should be examined on two planes. One is its impact on the bank lending rate and on credit; and the other is the steps taken to reduce the liquidity of the public's asset portfolio by altering the borrowing rate. In a perfect free money market there is no barrier between these two planes, but in Israel the money market is imperfect, and so there is a wide gap between the lending and borrowing rates, with only a fairly tenuous connection between them.

On the first plane, the monetary policy measures were aimed at making directed credit more expensive in 1977 and directly and indirectly reducing the supply of nondirected bank credit. This was reflected in the absorption of some IL800 million of the banks' freely loanable resources and the hiking of the penalty rates on liquidity deficiencies<sup>5</sup>. In view of the movement of the real rate of interest during 1977 and the relatively small contribution of monetary developments to the stimulation of domestic demands and acceleration of the price rise, it can be said that the monetary policy measures introduced in this sphere proved to be quite satisfactory.

But the action taken on the other plane did not achieve its objective: the absorption of liquidity from the public's asset portfolio by offering a higher interest on semiliquid money market assets. The reference is to the insignificant, ineffective raising of the

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<sup>5</sup> For a detailed description see Chapter XVIII.

Short-Term Loan yield (from 20 percent<sup>6</sup> to 22 percent gross).

## IMPLICATIONS OF THE FOREIGN CURRENCY REFORM ON MONETARY DEVELOPMENTS

The reform of the exchange rate system at the end of October 1977 has many important implications concerning the targets and method of implementing both monetary policy and the government's capital market policy, as well as the structure and development of the money and capital markets<sup>7</sup>.

With the lifting of most of the restrictions on the receipt of foreign currency credit from banks in Israel and abroad and elimination of the limitations on the purchase and holding of foreign currency, the economy is now more open than before to short-term capital movements in the private sector's balance of payments; in addition, there is an increased degree of substitution and greater possibilities for the public to shift between local currency assets and liabilities and those in foreign currency.

The floating of the exchange rate has greatly diminished the Bank of Israel's intervention in the foreign exchange market and altered the dimensions and character of such intervention. Today it is limited to moderating the impact on the exchange rate of short-term random factors affecting the demand and supply of foreign currency. Other changes in the market forces will be mainly reflected in the exchange rate rather than in the economy's foreign exchange reserves (and money base).

With the unification of exchange rates, which accompanied the floating of the IL and liberalization of foreign currency control, the exchange rate on financial transactions was adjusted downward by 47 percent. Besides the consequent big one-time capital gain and its effect on the composition of the public's asset portfolio this adjustment eliminated the foreign exchange risk which confronted those borrowing foreign currency (mainly for long terms) because of uncertainty over the timing of the change. On the other hand, the floating of the IL has added a new element of risk, which did not exist under the previous exchange rate system.

The implications of the revision of the exchange rate system can be summarized as follows:

(a) The influence of monetary expansion on the level of economic activity, the rate of change of the exchange rate, and level of prices in the economy has grown stronger.

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<sup>6</sup> Including the disagio.

<sup>7</sup> A detailed discussion of the reform and its implications appears in Chapter XVIII.

(b) The possibility of resorting to a restrictive monetary policy to counteract the expansionary influence of the public sector's demand surplus has diminished, because of the effect which the hiking of the domestic interest rate has on the inflow of capital from abroad, and hence on the exchange rate. On the other hand, monetary policy must now concentrate, more so than in the past, on preserving the fine balance between the return on Israeli currency assets and liabilities and the expected return on such items in foreign currency (the interest rate plus the anticipated percentage change in the IL exchange rate).

(c) Formerly it was possible to diagnose monetary developments and to control them almost exclusively through the local currency monetary variables; from now on there will be a growing need to keep tabs on domestic money market transactions in local and foreign currency alike and to carry out a balanced monetary policy. This problem is particularly acute in view of the sizable differential which existed on the eve of the reform between the return on local currency assets and liabilities and that in foreign currency, and also because of the imperfection of the Israeli money market, which permitted the creation of a wide gap between the lending and borrowing rates in local currency.

(d) Another important consequence of the reform is the fact that the steering of the exchange rate (and export profitability) in a direction that will reduce the current account deficit no longer depends on administrative decisions concerning the exchange rate, but will be mainly realized through fiscal and overall economic policy.

Since the introduction of the reform monetary expansion has been more rapid than indicated by the development of the local currency monetary variables. This is explained by the bulging at the end of 1977 and beginning of 1978 of the public's foreign currency deposits (demand and time) in particular, as well as by the greatly increased volume of nondirected credit granted in foreign currency. This steep rise in the public's foreign currency assets and liabilities is mainly an outcome of the highly imperfect state of the local market. Presumably its exposure to the competition of foreign currency would speed up the hoped-for process of perfecting the market. But as long as the public sector's huge liquidity injection is not significantly reduced and brought into line with the new reality of a small absorption via private purchases of foreign currency, and as long as the liquidity requirements are not adjusted to the new situation of a greater substitution between foreign and local currency, there exists a grave danger of a continued acceleration of monetary expansion with all its negative implications.