CHAPTER XVI

FLOW OF FUNDS

1. Conceptual Framework[1]

The flow-of-funds system is a statistical framework which describes the financial transactions accompanying economic activity; it provides a means of studying the influence of the various sectors on such activity and their mutual financial relationships.

The flow-of-funds system presented here analyzes the activity of nine sectors, classified into three broad groups:

(a) Real (i.e. nonfinancial) domestic sectors. These are domestic sectors mainly active in the production and consumption of goods and services. This group includes households, nonfinancial business firms,[2] the public sector (Government, National Institutions, and local authorities), public sector companies,[3] and nonprofit institutions.

(b) Domestic financial sectors: the banking system (banking institutions and the Bank of Israel), financial institutions (mainly mortgage and development banks and investment companies), social insurance funds, and insurance companies.

(c) The rest-of-the-world sector: all economic units outside the Israeli economy.

This classification is essentially different from that of the conventional system of national accounts. In flow-of-funds analysis the sectorial classification of economic units is according to the characteristics which determine their behavioral pattern (as a rule, field of activity and ownership). The classification in the national accounts is mainly according to the economic function of the units (consumption, investment, etc.).[4]

[1] A detailed description of flow-of-funds analysis can be found in M. Heth, *Flow of Funds in the Israeli Economy, 1959–1966,* Bank of Israel, Jerusalem, 1968.

[2] Owing to the lack of reliable data, it is generally impossible to distinguish between the transactions of households and private businesses, and much of the analysis of the relationships between them is conjectural. Where the two cannot be separated, the combined sector will be called the "private sector".

[3] Public sector companies are firms operating as autonomous legal entities (as distinct from the Post Office and Israel Railways, for example), and at least 25 percent of whose equity capital is owned by public sector authorities, which actively participate in their management. They include Amidar, Mekorot, Israel Electric Corporation, Zim, El Al, Rassco, and others.

[4] The rest-of-the-world and public sectors are the only ones that appear in both systems. In the national accounts, the public sector includes in certain cases nonprofit institutions.

The flow-of-funds system describes two types of intersectorial transactions:

(a) Real transactions: purchase and sale of goods and services (on current and capital account), transfer payments (mainly taxes and grants), and transfer receipts.

(b) Financial transactions: the grant and receipt of credit through all the various financial instruments in the capital market.

Unlike the flow-of-funds system, the national accounts do not show the financial transactions of domestic sectors.[1] The two systems also differ in the definition of some real transactions.[2]

Data on money flows are obtained from the receipts and payments (or resources and uses) accounts of the sectors, which are generally referred to as the sectorial "balance of payments". There is in fact a conceptual resemblance between the structure of these accounts and that of the country's balance of international payments. Real transactions may be compared to the country's goods and service account (purchases resemble imports and sales resemble exports), while financial transactions may be compared to the capital account. The financial transactions are combined into a matrix of intersector credit flows.

Flow-of-funds analysis assumes that in a modern economy, where most economic activity is connected with money flows between economic units, real and financial transactions are influenced by the financial aspects. Therefore, developments in the capital market can help in understanding developments in the real market.

Flow-of-funds analysis is at two levels: the assessment of sectorial contributions to aggregate demand, and a comprehensive presentation of developments in the capital and financial markets.

Aggregate demand analysis relies on two indicators: One is the demand surplus of all the sectors and changes therein. This magnitude is defined as the difference between a sector's income from the sale of goods and services and domestic transfer receipts on the one hand, and its expenditure on capital and current account and its domestic transfer payments on the other. A sector with a demand surplus must resort to external financing, which may be domestic or foreign credit or unilateral transfers from abroad.

A sector's demand surplus represents the difference between the sector's use of and its contribution to the supply of real resources;[3] hence the demand sur-

1 The conventional national accounting system includes the financial transactions of one sector only—the rest of the world.

2 The definition of purchases on capital account is not identical with the definition of investment in the national accounts, although most of the components coincide. Another difference is that imputations are excluded from the flow-of-funds system.

3 A sector's receipts from sales and domestic transfers absorb funds from other domestic sectors, reducing the purchasing power of the latter while correspondingly increasing its own. It should be noted that ex-post data show the *results* of demand pressure. An increase in the demand surplus of a sector does not necessarily mean that it originated in the sector itself: the demand surplus of a sector is apt to increase with a rise in its expenditure,

plus, and particularly changes therein, indicate the sector's influence on aggregate demand.

The second indicator is the amount of credit which a sector makes available to finance the demand surpluses of other sectors. In general, sectors that are net lenders have a surplus. However, a sector can have a demand surplus and still provide net credit to other sectors, if its unilateral transfers from abroad exceed its demand surplus. In many cases it is difficult to establish a causal connection between the creation and financing of a demand surplus. In other words, it cannot be determined from the money-flows structure whether the availability of funds induced a sector to increase demand, or whether the increase of demand necessitated recourse to external sources of funds.

The second type of money-flows analysis concentrates on various aspects of activity in the securities and credit markets, as described in the credit-flows table.

The usefulness of flow-of-funds analysis is greatly circumscribed because of theoretical and technical problems that have not yet been solved. On the theoretical plane, there is no body of theory comparable, for example, to input-output theory, which is based on a statistical framework with characteristics similar to those of the money-flows structure.

On the technical plane, the analysis is limited by the absence of data permitting the segregation of the real transactions and part of the financial transactions of the private business sector from those of households. This deficiency is particularly serious in view of the dissimilar nature of these two subsectors and their substantial weight in economic activity.

Another shortcoming is the lack of quarterly or half-yearly data. This causes difficulties in analyzing economic developments in a year when the trend of economic activity turns—as happened in 1967.

2. Main Developments

In 1967 the two main sectors influenced economic activity in opposite directions: the private sector showed deflationary tendencies, while public sector operations had an expansionary effect on demand. This pattern started in 1965, grew more pronounced in 1966, and reached unprecedented proportions in 1967.

For the first time since 1959 (when flow-of-funds analysis was instituted), the private sector had a large supply surplus of IL 919 million, compared with

while the demand pressure which pushed up prices and costs may have originated in other sectors. This problem of interpreting ex-post data exists also in the conventional analyses of national product determination.

a IL 71 million demand surplus in 1966.[1] The supply surplus stemmed from a steep decline in business investment and household purchases of dwellings, accompanied by an increase in household and probably business saving.

The public sector's demand surplus shot up from IL 910 million in 1966 to IL 1,894 million, as a combined result of the much larger defense expenditure and the reflationary monetary and fiscal policies designed to stimulate economic activity.

The opposite trends in these two sectors influenced the growth of national product during the year. The first half saw a heightening of the deflationary pressures originating in the private sector, and GNP failed to expand. In the middle of the year, the huge increase in Government spending led to the resumption of economic growth, reflected by a rise in employment and national product.

The decline in private investment in 1967 is attributable to the recession and the concomitant uncertainty and pessimistic outlook.

Business investment began to fall off in 1965 and continued downward in 1966; in part this was a natural reaction to the high level of capital formation up to 1964, but to some extent it was also connected with the virtual cessation of immigration. The initial decline picked up speed, as it gave rise to unemployment, which in turn further slowed down the growth of demand and national product. Moreover, in the prevailing pessimistic climate many households put off the purchase of dwellings and consumer durables and increased their financial savings.

The decline in private sector purchases on capital account, accompanied, as stated, by a rise in household saving in the form of financial assets, resulted in the generation of a supply surplus in 1967. It is reasonable to assume that households had a supply surplus in previous years as well, but in 1967 it greatly exceeded the demand surplus of the business sector.

The public sector demand surplus grew because of both increased expenditure and reduced receipts. On the expenditure side, the principal factor was heavy defense spending, and to a lesser extent the steps taken to revive the economy. As to receipts, taxes and other net transfers declined, reflecting the policy designed to keep private incomes and aggregate demand from falling.

The development of the sectorial demand and supply surpluses in 1967 and the employment situation affected the importance of the rest-of-the-world sector as a source of funds. The generous response of World Jewry to the efforts to raise funds abroad (unilateral transfers and credit) enabled the public sector to finance a large part of its demand surplus through such receipts. In addition, the sector received more credit from the banking system as compared with

[1] The private sector figures in the flow-of-funds system are residuals, containing the errors and omission of the other sectors, and they should therefore be treated with caution. This shortcoming was especially serious in 1967, owing to the magnitude of the "errors and omissions" item in the country's balance of payments.

Table XVI-1

INDICATORS OF THE INFLUENCE OF REAL DOMESTIC SECTORS ON TOTAL DEMAND, 1965–67[a]

(IL million)

	Demand or supply (–) surplus	Net credit to or from (–) real domestic sectors[b]	Errors and omissions	Net credit from or to (–) financial sectors[c]	Net credit and transfers from abroad[d]
	(1)	(2)	(3)	(4)	(5)
Private business and households					
1965	430	–99	–94	–445	870
1966	71	31	–102	–288	492
1967	–919	42	–402	–994	469
Public sector					
1965	668	406	—	241	833
1966	910	225	–6	466	675
1967	1,894	314	19	827	1,362
Public sector companies					
1965	336	–262	–5	77	2
1966	199	–219	—	46	–66
1967	265	–335	–3	18	–85
Nonprofit institutions					
1965	217	–45	2	14	156
1966	221	–37	2	36	146
1967	164	–21	12	–5	136
All real domestic sectors					
1965	1,651	—	–97	–113	1,861
1966	1,401	—	–106	260	1,247
1967	1,404	—	–374	–104	1,882

[a] The figures for 1965 and 1966 have been revised. Devaluation differentials have not been treated as a flow of credit. The demand surplus (1) plus credit granted to other real domestic sectors (2) is conceptually equal to credit and transfers from abroad (5) plus credit from the financial sectors (4). Discrepancies in totals are due to omissions and the rounding-off of figures.

[b] Credit given by the sector to other real domestic sectors, less the credit received from them (a minus sign denotes that the sector was a net recipient of credit).

[c] Credit received from the financial sectors (including the banking system), less credit given to them (including the increase in bank deposits). For the nature of the credit to the banking system, see explanation in the text.

[d] Transactions of the domestic sectors with the rest of the world in 1967 have been recorded at IL 3.06 per dollar, the average exchange rate in effect during the year.

1966. The demand surplus was thus financed entirely from sources expanding the liquidity of the economy.

Despite the huge growth of public sector outlays and the manner in which they were financed, no inflationary pressures were generated thereby. Neither the import surplus nor the price level rose, and this made it possible to build up the country's foreign currency reserves.

There were two main reasons why the sector's operations did not create inflationary pressures or widen the import surplus. First, the supply surplus of the private sector, which resulted in the underemployment of productive factors, kept inflationary pressures from arising despite the expansion of aggregate demand and liquidity. The decline in private investment and consumption released real resources to satisfy public sector demand. The second factor was the low import component of those public sector ontlays which grew most rapidly in 1967.

The private sector supply surplus was the outcome of an increase in the supply surplus of households and a decline in the demand surplus of businesses. Since there is a connection between changes in the demand surplus of the latter and those in its credit receipts, the reduction of the demand surplus is reflected by the curtailment of credit from other domestic (particularly financial) sectors. The rise in the households' supply surplus stemmed from both increased saving and smaller home purchases, and hence was reflected by an appreciable growth of financial asset holdings (bank deposits and securities).

The capital market was affected in various ways in 1967 by changes in the level and nature of activity in the different sectors. Apart from the public sector, the real domestic sectors received less net credit from the financial sectors in 1967. This was the net result of a decrease in the gross credit receipts of businesses and nonprofit institutions and a rise in household deposits, all connected with the recession. Public sector companies were able to step up their real activity besides granting and repaying more credit, thanks to much heavier borrowing from the public sector.

The public sector expanded its financial operations in 1967. It granted more gross credit to domestic sectors (mostly in the form of long-term development budget loans), but it also mobilized more funds through bond issues, so that the net credit outflow was only slightly larger than in 1966. The increase in long-term lending was designed to encourage investment, while the greater recourse to bond issues was intended to absorb some of the considerable liquidity injected into the economy.

The large-scale monetary expansion of 1967 resulted in an impressive growth of business and household holdings of cash and demand deposit balances. Households also substantially increased their saving scheme, foreign-currency (Taman and Pazak), and local-currency time deposits in banking institutions. In part this represented a growth of household saving, and in part it was due to a shift from investment in the bill brokerage trade.

Receipts of social insurance funds and insurance companies also went up in 1967 (despite falling employment and wage stability). At the same time, they granted more credit, but its composition underwent a change: the percentage going to the public sector by way of bond purchases rose and that to other sectors dropped. The activities of financial institutions both in raising capital and in supplying credit contracted, owing to the reduced demand for borrowed funds.

3. Demand Surpluses, by Sector

The changes in the magnitude of the sectorial demand surpluses in 1966 and 1967 found expression in the development of the national product, price level, and import surplus.

The decline in the demand surplus of the private sector and public sector companies in 1966 generated strong deflationary pressures, which were not offset by the growth of the public sector's demand surplus. As a result, there was a standstill in GNP, accompanied by the narrowing of the import surplus and the firming of prices (as from the middle of the year).

In 1967 the sectorial surpluses developed in the same direction as in the previous year. However, aggregate demand apparently expanded appreciably in the second half of the year, when recovery set in, increasing employment and the national product.

Changes in the demand surplus of the private sector are by definition a function of changes in the sector's investment, income, and saving patterns. The available data do not permit a separate analysis to be made for the two segments of the sector.[1] Nevertheless, there is reason to believe that in 1966 and 1967 the demand surplus of both businesses and households decreased; even though there is no direct quantitative proof of this, Table XVI–3 lends some support to the supposition.

This table shows that the demand surplus of business firms decreased in both 1966 and 1967, while the supply surplus of households increased in both

[1] As stated, this severely limits the usefulness of flow-of-funds analysis, since households and businesses do not affect the aggregate demand surplus in the same way. In many economies, and presumably in Israel, business saving is not sufficient to finance the firms' investments, and this subsector usually has a demand surplus. Households, on the other hand, generally have a supply surplus.

In Israel, households too may have had a demand surplus in some of the last few years. If so, it was made possible by the large-scale foreign unilateral transfers, which served *inter alia* to increase both consumption and investment in housing.

In addition to these statistical shortcomings, there is a conceptual problem in distinguishing between the behavioral patterns of the two subsectors because of the considerable weight of unincorporated businesses and self-employed persons in Israel's economy.

Table XVI-2

DEMAND OR SUPPLY SURPLUSES, BY SECTOR, 1965–67[a]

(IL million)

	Purchases: On current account (1)	Purchases: On capital account (2)	Sales (3)	Net purchases (1)+(2)−(3) (4)	Transfers: To domestic sectors (5)	Transfers: From domestic sectors (6)	Net transfers (5)−(6) (7)	Demand or supply(−) surplus (4)−(7) (8)
Private business and households[b]								
1965	6,411	1,801	×	×	×	×	×	430
1966	7,086	1,326	×	×	×	×	×	71
1967	7,274	769	×	×	×	×	×	–919
Public sector[c]								
1965	2,531	610	255	2,886	840	3,058	2,218	668
1966	3,053	642	370	3,325	1,067	3,482	2,415	910
1967	3,915	504	355	4,064	1,280	3,450	2,170	1,894
Public sector companies[d]								
1965	912	484	1,042	354	12	30	18	336
1966	926	343	1,046	223	16	40	24	199
1967	1,012	450	1,162	300	20	55	35	265
Nonprofit institutions[e]								
1965	694	130	156	668	25	476	451	217
1966	797	160	207	747	24	550	526	221
1967	826	127	222	731	23	590	567	164
Social insurance funds and insurance companies[f]								
1965	178	9	195	–8	170	191	–21	–29
1966	214	13	222	5	192	224	–32	–27
1967	232	3	251	–16	225	228	–3	–19
Banking system[g]								
1965	340	16	416	–60	53	—	–53	–7
1966	437	13	526	–76	70	—	–70	–6
1967	495	14	602	–93	91	—	–91	–2
Financial institutions[h]								
1965	181	6	234	–47	37	—	–37	–10
1966	238	7	292	–47	38	—	–38	–9
1967	269	–4	322	–57	40	—	–40	–17
Rest of the world[i]								
1965	2,132		3,737	–1,605	—	—	—	–1,605
1966	2,496		3,855	–1,359	—	—	—	–1,359
1967	2,816		4,182	–1,366	—	—	—	–1,366

[a] The figures for 1965 and 1966 have been revised. Transactions with the rest-of-the-world sector in 1967 have been evaluated at the rate of IL 3.06=$ 1.

[b] Calculated as a residual by deducting the demand surpluses of other sectors from the supply surpluses.

[c] As defined in Chapter VII, "Public Sector Operations", except that here sales include interest received and purchases include interest paid by the National Institutions to the rest of the world.

[d] Companies in which the public sector holds at least 25 percent of the equity capital and actively participates in the management.

[e] As defined in Chapter VIII, "Nonprofit Institutions".

[f] As defined in Chapter XVIII, "Social Insurance Funds and Insurance Companies".

[g] Commercial banks, cooperative credit societies, and the Bank of Israel.

[h] As defined in Chapter XVII, "Financial Institutions".

[i] Sales are identical with imports as recorded in the balance of payments, and purchases with exports, adjusted for overseas expenditure of the National Institutions.

years.[1] It also indicates that the business sector was mainly responsible for the creation of the private sector supply surplus in 1967: its demand surplus decreased by IL 502 million, while the supply surplus of households rose by IL 188 million. However, the figures probably overstate the contribution of business to the supply surplus and understate that of households. There are grounds for believing that in 1966 business firms substantially increased their net flow of credit to households (in their attempt to reduce inventories, particularly of dwellings), and that households repaid a large part of this incremental credit in 1967. If this was so, the contribution of business in 1967 was smaller than indicated above and that of households larger (see explanation in section 6, "Credit Flows").[2]

As already pointed out, in 1967 the supply surplus of households for the first time exceeded the demand surplus of businesses, and the combined sector showed a supply surplus. In other words, its current income was higher than its purchases on current and capital account and it provided considerable credit to other sectors.

The growth of the supply surplus of households in 1967 differed essentially from that of the previous year. In 1966 the supply surplus[3] of households increased because housing investment fell by more than did total saving[4] (this is tantamount to an increase in purchases of financial assets).[5]

The growth of financial asset holdings (mainly bank deposits, securities, contributions to social insurance funds and insurance companies) and their increased weight in total household saving were connected with the recession: many households deferred the purchase of dwellings and consumer durables because they were uncertain as to how incomes would change and they expected prices to drop. The distribution of incomes also changed: there was apparently a rise in the share of those groups with a high propensity to save in the form of financial assets.[6]

In 1967 both the saving and the supply surplus of households grew. The 1966 saving trends continued and accentuated the rise in the supply surplus: savers continued to prefer financial to real assets, because the uncertainty and pessimism of the preceding year persisted and because of the relatively higher

[1] The indirect estimate is not independent of the global private sector residual figure shown in Table XVI–2, but in the absence of saving and investment data for each of the two subsectors, their demand surpluses cannot be calculated separately.

[2] Another factor, also discussed later, is the upward bias in the estimated amount of bill brokerage credit received by businesses in 1966.

[3] The supply surplus of households is defined as the difference between their gross saving and gross investment.

[4] See Chapter XIX, "Saving", for a discussion of the changes in household saving in 1966 and 1967.

[5] The supply surplus of households is defined as the difference between gross saving and gross investment in real assets.

[6] See Bank of Israel Annual Report for 1966, p. 410.

Table XVI–3

INDIRECT ESTIMATE OF HOUSEHOLD AND BUSINESS SECTOR SURPLUSES, 1965–67[a]

(IL million)

	1965	1966	1967
Households			
Net credit received[b]	55	76	70
Transfer receipts from abroad	601	577	588
(1) Total financial resources	656	653	658
(2) Net credit granted[b]	805	1,026	1,219
(3) Indirect estimate of supply surplus (1–2)	–149	–373	–561
Business			
(4) Net credit received[b]	686	627	174
(5) Net credit granted[b]	13	81	130
(6) Indirect estimate of demand surplus (4–5)	673	546	44
Private sector			
Indirect estimate of demand or supply (–) surplus (3–6)	524	173	–517
Residual estimate of demand or supply (–) surplus[c]	430	71	–919
Difference between estimates[d]	94	102	402

[a] Devaluation differentials accruing as a result of the November 1967 devaluation are not treated as credit flows.
[b] According to Table XVI–6.
[c] As shown in Table XVI–2.
[d] Identical with errors and omissions for the private sector in Table XVI–4.

yield on financial investments. However, economic developments in 1967 did not display a uniform trend. The available data do not make it possible to establish precisely how the deflationary influence of households was spread over the year; but data on sales of housing and durable goods during the year and on the rate of consumption out of disposable income suggest that the deflationary pressures originating in this sector were much weaker in the second than in the first half of the year.

The demand surplus of business enterprises apparently changed in the same direction as that of households, but not to the same degree. In both 1966 and 1967 the dominant factor was the decline in capital expenditure. In 1966 business saving remained stable (or declined slightly), and consequently the sector's demand surplus decreased. This is borne out by the calculations of Table XVI–3 and an estimate computed from data on a group of industrial companies.[1] In 1967 the demand surplus of businesses continued downward, as the result of a further decrease in capital spending and an increase in saving.[2] In other words, the demand surplus dropped by more than did purchases on capital account.

The public sector was a source of considerable demand pressure in 1967. This was sufficient to offset the deflationary tendencies originating in the private sector, and to lead to a growth of national product. But it was only in the second half of 1967 that the expansionary effects of public sector operations outweighed the contractionary influence of private sector activity. It was the enormous rise in public sector spending as from the middle of the year that got the wheels of the economy moving again.

The public sector's share in aggregate demand began moving upward in 1965, and it reached unprecedented proportions in 1967. The increase in the sector's demand surplus was the combined result of heavier defense spending, the measures taken to combat unemployment and stimulate economic activity, and the decline in tax receipts and transfers from the public (see Chapter VII, "Public Sector Operations"). All of the incremental public sector demand was on current account. On capital account, the larger investment of public sector companies failed to offset the decline in total investment: the combined capital-account purchases of the public sector and public sector companies fell by IL 31 million in 1967, and those of the private sector by IL 557 million.

The demand surplus of public sector companies, which had dropped steeply in 1966, went up in 1967. Changes here are closely connected with fluctuations in purchases on capital account, owing to the small percentage of capital outlays financed from internal sources. Most of the additional investment in 1967 was in mining and quarrying and in shipping; construction and housing investment remained at its low 1966 level.

The demand surplus of nonprofit institutions shrank in 1967, for two reasons. First, net purchases declined: current purchases rose more slowly than in 1966, while capital purchases fell off in absolute terms. Secondly, some of the sector's demand surplus was "shifted" to the public sector, which stepped up its transfers to nonprofit institutions.

The changes in the demand surpluses of the real domestic sectors illustrate the course of the recession, which began with the curtailment of investment in

[1] The data relate to a sample of 84 large industrial companies belonging to the private sector. In 1966 their gross investment dropped by 30 percent (a rate similar to that for industry and construction as a whole), while gross saving held steady. This means that the demand surplus of the 84 concerns decreased by the full amount of the reduction in investment. Although the sample is not representative of the entire sector, the results lend support to the assumption about the relative intensity of changes in gross saving and investment.

[2] The assumption that business saving increased in 1967 is based on indicators showing a rise in profitability compared with 1966. See Chapter II, "Resources, Uses, and Incomes".

the private sector and by public sector companies, in response to the excess supply created by the rapid and continuous growth of the years up to 1964;[1] the investment of public sector companies was cut back in 1966 under the Government's policy of economic restraint. This decline in capital formation slowed down the growth of incomes, led to the underemployment of productive factors, and bred pessimistic expectations among businesses and households. These expectations in turn accentuated the decline in aggregate demand by altering saving patterns in favor of financial savings at the expense of investment in housing.

Developments in the financial markets during the recession failed to offset the inflationary tendencies originating in the private sector. Despite the efforts to reduce the price of money and to expand credits as from the second half of 1966, the falling investment trend was not checked until the middle of 1967. Evidently the pessimistic outlook prevailing in the economy neutralized the incentives offered to stimulate investment. Moreover, the lowering of the nominal yield on various financial assets was insufficient to induce the curtailment of saving in this form and correspondingly increase demand in the real markets.[2]

The Government's fiscal policy was aimed at checking the decline in private sector demand, but not in full.[3] It appears that until the first half of 1967 the restrictive effect of private sector operations outweighed the expansionary influence of public sector activity, and it was only after the enormous growth of public sector spending (mainly for security purposes) in the second half of the year reviewed that a reversal of economic trend became discernible.

4. Financing the Demand Surpluses[4]

Economic developments in 1967 led to a marked change in the financing of the demand surpluses of the real domestic sectors (see Table XVI–4). It became necessary to finance the steep rise in the public sector's demand surplus, while in the private sector investments fell off and purchases of financial assets were increased to such an extent as to create a supply surplus. The developments in the private sector affected public sector financing, both directly and indirectly.

[1] See Chapter V, "Domestic Investment".

[2] This is discussed in Chapter XV, "Money Supply, Credit, and the Banking Institutions".

[3] A further instrument available to the public sector for regulating domestic demand is its control of investment activity by public sector companies. In 1967 the expansion of such investments helped to arrest the fall in aggregate demand. In 1966, on the other hand, the curtailment of the companies' capital expenditures accentuated the deflationary tendencies arising from the reduction of private investment.

[4] Owing to the magnitude of the errors and omissions item in the country's balance of international payments in 1967, the discussion in this section should be treated with considerable reserve. The wide divergence in the estimates of the demand surplus in Table XVI–4 as derived from real and from financial transactions originates in these errors and omissions.

Table XVI–4

FINANCING OF DEMAND SURPLUSES, BY SECTOR, 1965–67[a]

(IL million)

	From rest of world[b]		Domestic sectors		Total net credit received or granted(–) (2)+(3) –(4)	Errors and omissions	Demand or supply(–) surplus (1)+(5) +(6)
	Transfers	Net credit	Net credit received[c]	Net credit granted[d]			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Private business and households							
1965	601	269	236	582	–77	–94	430
1966	577	–85	703	1,022	–404	–102	71
1967	588	–119	244	1,230	–1,105	–402	–919
Public sector							
1965	287	546	241	406	381	—	668
1966	183	492	536	295	733	–6	910
1967	899	463	943	430	976	19	1,894
Public sector companies							
1965	—	2	364	25	341	–5	336
1966	—	–66	312	47	199	—	199
1967	—	–85	437	84	268	–3	265
Nonprofit institutions							
1965	156	—	59	—	59	2	217
1966	146	—	76	3	73	2	221
1967	136	—	29	13	16	12	164
Social insurance funds and insurance companies							
1965	—	2	257	286	–27	–2	–29
1966	—	–4	323	333	–14	–13	–27
1967	—	—	380	390	–10	–9	–19
Banking system							
1965	—	–225	535	318	–8	1	–7
1966	—	70	684	763	–9	3	–6
1967	—	–221	795	611	–37	35	–2
Financial institutions							
1965	—	63	164	239	–12	2	–10
1966	—	133	201	372	–38	29	–9
1967	—	60	162	232	–10	–7	–17
Rest of the world							
1965	–1,044	—	—	—	–657	96	–1,605
1966	–906	—	—	—	–540	87	–1,359
1967	–1,623	—	—	—	–98	355	–1,366

[a] The figures for 1965 and 1966 have been revised. Devaluation differentials accruing as a result of the November 1967 devaluation are not treated as credit flows.
[b] In 1967 transactions with the rest of the world were recorded at IL 3.06/$ 1, the average exchange rate during the year.
[c] Sum of columns in Table XVI–6, less credit from the rest of the world.
[d] Sum of rows in Table XVI–6, less credit to the rest of the world.

The private sector financed the public sector directly through its purchases of Government securities (including the Absorption and Defense Loans). Moreover, in order to finance its much larger expenditure, the public sector mobilized funds abroad and borrowed heavily from the banking system; that this did not generate inflationary pressures was due, among other things, to the private sector's large investment in financial assets.

The much larger volume of unilateral receipts received by the public sector from abroad in 1967 did not expand the supply surplus of the rest-of-the-world sector (the country's import surplus), owing to the slackness of economic activity in the real domestic sectors; this permitted the accumulation of foreign exchange reserves.

In the present context too, it is necessary to discuss the household and business segments of the private sector separately.

Most of the growth in the supply surplus of households in 1966 and 1967 was reflected by larger purchases of financial assets. The incremental credit went mainly to the public sector, the banking system, social insurance funds, and insurance companies.

The 1966 decline in the demand surplus of businesses was accompanied by a sharply reduced volume of foreign borrowed receipts and an increase in credit from domestic financial sectors.[1] The decrease in capital transfers was closely connected with the decline in domestic investment. The latter development, which signalled the onset of the recession, presumably reduced the volume of private capital transfers for investment purposes, and this in turn further reduced investment and demand, thereby aggravating the business slump.

Part of the incremental bank credit received by businesses in 1966 was for financing the involuntary expansion of inventories and customer credit, particularly in the construction and housing sector. The data in Table XVI–6 probably do not fully describe how the business sector financed its demand surplus: bill brokerage credit has been treated as receipts from banking institutions, but apparently it includes funds received by other sectors, so that the figure on bank credit received by businesses is overstated. Nor are there data on the incremental credit which businesses apparently granted to households in 1966.[2]

In 1967 the net amount of credit extended to business firms by the financial sectors continued downward. The decline in bank credit was particularly steep: in 1966 business received IL 433 million (net), while in 1967 it gave IL 23 million (net) to the banking system (this is discussed more fully in section 6, "Credit Flows").

The public sector required an unprecedented amount of funds in 1967 to

[1] Foreign credit raised by private business in 1965 came to IL 287 million, while in 1966 repayments and loans granted to the rest of the world totalled IL 57 million. These figures are obtained as residuals and should be treated with reserve, owing to the magnitude of the errors and omissions item in the country's balance of payments.

[2] See Bank of Israel Annual Report for 1966, p. 412, and the discussion below.

finance its activities—IL 1,894 million to cover the demand surplus and IL 430 million to grant net credit to other domestic sectors; this was nearly double the sum required in 1966.

Because of the standstill in national product and mounting unemployment in the first half of 1967, the public sector resorted to expansionary sources of finance: the entire increase in its expenditure was covered by unilateral transfers and credit from abroad and by bank credit. The additional foreign finance was raised through the emergency appeals and the larger sale of Development Bonds.[1]

In 1967, especially the second half of the year, the public sector also stepped up its nonbank borrowing at home, principally through the Defense Loan and other Government loans. This presumably reflected its desire to avoid adding to the large amount of liquidity injected into the economy in the first half of the year.

Despite the larger amount of money absorbed from the public, net public sector credit to the real domestic sectors rose somewhat, in contrast to 1966, when the growth of the public sector's demand surplus and borrowed receipts from the banking system was accompanied by a much smaller net credit outflow to the other sectors.[2]

The rise in the demand surplus of public sector companies was accompanied by a larger rise in net credit from the public sector, so that the companies were able to repay foreign debts, increase bank deposits, and reduce their net credit inflow from financial institutions.[3] In the last three years net credit from the public sector grew faster than the companies' demand surplus, bringing up the share of the public sector in the companies' sources of finance.

In 1967 the demand surplus of nonprofit institutions decreased by more than their foreign transfer receipts, so that they were able to cut down on their net borrowing. This apparently reflected their desire to adjust the volume of their activities in line with their income and unilateral transfers from abroad and from domestic sources. It is reasonable to assume that because of their nonprofit nature the institutions were reluctant to borrow to the same extent as in 1965 and 1966, which were years of particularly vigorous activity, marked by big wage hikes and capital outlays.

The aggregate demand surplus (i.e. the import surplus) of the economy is financed by unilateral transfers and credit from abroad. In 1967 circum-

[1] The public sector deposited approximately $ 100 million abroad. If these sums had been transferred to the Bank of Israel, the sector's net bank credit receipts would have been reduced while its receipts from the rest of the world and net bank credit to the rest of the world would have risen by the same amount.

[2] The effect of the smaller net credit outflow on aggregate demand in 1966 is discussed in the Bank of Israel Annual Report for 1966, p. 411.

[3] Those public sector companies that gave and repaid credit abroad in 1967 received considerable net credit from the public sector.

stances permitted a considerable increase in the capital inflow. The import surplus, however, did not rise, owing to the low level of private demand and the low import component of public sector demand. As a result, the country's foreign currency balances were augmented.

5. The Financial Sectors in the Money-Flows System

The role of the financial sectors is primarily to lubricate the processes of saving and investment. Few of their transactions are connected with the sale and purchase of goods and services, and since demand or supply surpluses originate in real transactions, the financial sectors do not have large surpluses in either direction; hence their activities are hardly reflected in Table XVI–2. Nor does Table XVI–4 tell us anything about the most significant aspect of their financial transactions, which is the sectorial composition of the sources and uses of their funds, rather than the magnitude of the credit inflows and outflows, which necessarily more or less match.[1]

Before summarizing the intersector credit flows, we shall briefly describe the characteristics distinguishing the financial sectors from the standpoint of the sources and uses of their funds.

(a) *The banking system*

This sector differs from the other financial sectors in two respects. The first is connected with the fact that a large percentage of its liabilities constitute means of payment. The other financial sectors can give credit only if they have succeeded in raising funds. The banking system is not subject to this constraint: by giving credit it creates means of payment, which are classified as "sources of funds" in the flow-of-funds system, although they differ essentially from the sources of the other financial sectors.

Secondly, until 1965 the banking system was a net lender to the rest of the world, since the accumulation of foreign currency balances by the Bank of Israel is, conceptually, credit granted to the foreign sector.

In 1967 bill brokerage transactions were classified as flows through the banking system, whereas they were formerly recorded as direct flows between households and business.[2] The reason for the change is that in bill brokerage the banking institutions determine both the debitory and creditory rate of

[1] In general, money flows through the financial sectors are ignored when the financial intermediary is not at liberty to decide on their allocation. For example, credit granted from earmarked Government deposits is not considered a flow of money through the financial sectors, but is recorded as going directly from the public sector to the borrower. However, it is not possible to isolate all such flows, and some of them are recorded as passing through the financial sectors.

[2] The rationale of this approach is that formally the banking institution is not a direct party to the bill brokerage transaction.

interest, decide on the allocation of the credit, and guarantee the loan. These functions justify treating bill brokerage as transactions in which the banking institutions raise the funds and allocate them among the various borrowers.[1]

(b) *Social insurance funds and insurance companies*

This sector is the principal channel for household saving. It raises the bulk of its funds from households but does not act as an independent financial intermediary when it comes to allocating them. Most of its investments are subject to Government control: social insurance funds must invest at least 80 percent of their accumulation in securities approved by the Treasury (half of the approved investment is channelled to Histadrut enterprises and institutions); most of the investment of insurance companies is in securities of the Government and public sector companies. This control over the allocation of the sector's funds gives the Government a predominant position in the securities market.

(c) *Financial institutions*

This group of financial intermediaries operates chiefly in the long-term credit market, raising most of its funds by selling bonds to social insurance funds and obtaining credit abroad and from the banking system.[2] The Government largely directs these sources of finance, regulating their volume and determining their price and allocation. Most of the credit provided by this sector is for financing business investment and the purchase of dwellings by households.

In addition to the above-mentioned sources of funds, a large percentage of the public sector's earmarked deposits are held by the financial institutions, which are responsible for the technical arrangements connected with the grant of credit and the collection of principal and interest, but do not determine the allocation. As stated, these flows are not included in the figures for this sector.

(d) *The securities market*

The securities market also fulfils a role of financial intermediation, particularly through its new issue activity. In Israel this is primarily a bond market, although in 1962–64 an appreciable amount of equity capital was also raised. The allocation of the funds mobilized in this market is largely controlled by the Government, which influences both demand and supply.[3]

In November 1966 the Government Short-Term Loan ceased to be an instrument for mobilizing funds to finance the Government budget and became an instrument of Bank of Israel monetary policy. This change has not affected the status of the Short-Term Loan as a portfolio asset of savers.

1 See "Bill Brokerage in Israel, 1963–67", Bank of Israel Bulletin, No. 30 (March 1968).

2 Most of the credit received from the banking system is in the form of purchases of financial institution bonds with the funds of bank-administered saving schemes.

3 See Chapter XX, "The Securities Market".

The country's long-term capital market is characterized by two forms of Government intervention: (1) the mobilization of a large volume of finance in Israel and abroad and its direct allocation, and (2) control of the price and destination of the credit flowing through financial intermediaries.

Market forces, however, are decisive in repect of short-term credit. Neither the allocation nor the price of bill brokerage credit is controlled, and the same applies to credit granted from the banks' own resources. However, the Interest Law sets a ceiling on the price of bank credit, and some of it is also controlled by the Bank of Israel.

Interest rates did not change to the same extent in the long- and short-term markets, and this difference is connected with the degree of Government intervention. In 1966 and 1967 the recession and savers' preference for financial saving generated downward pressure on interest rates, and in the money market (short-term financing) both the debitory and creditory interest rates fell.

In the long-term capital market, the larger offer of funds and the decline in private sector demand failed to depress creditory interest rates, owing to soaring public sector demand. Some borrowers, however, enjoyed better terms, thanks to the Government's policy of stimulating economic activity by making money cheaper for investors and home buyers. As the financial institutions operating in this market had to pay the same price as before for the funds which they mobilized, the Treasury arranged to compensate them for the differential.[1]

6. Credit Flows[2]

This section fills out the picture obtained from the data on the financing of demand surpluses (or the uses of supply surpluses), by tracing the credit flows and the network of financial relationships that accompany the saving and investment of the real sectors. It may be said, for instance, that it was the household supply surplus that made it possible to finance the public sector demand surplus, by releasing real resources. But the transferring of resources does not, for the most part, entail direct flows. Households save mainly in the form of bank deposits and the purchase of claims on social insurance funds and insurance companies, and only a small part of their financial savings goes directly as credit to the public sector.

It is important to distinguish between the information presented in Tables XVI–5 and XVI–6. Intersector credit flows are often bilateral. Thus, the public sector borrows from households by issuing bonds, and it also lends them money to buy homes. Social insurance funds, to take another example, receive

[1] These arrangements are described in Chapter XX, "The Securities Market".

[2] It should be recalled that the credit flows shown in the tables in this chapter do not include changes in the value of financial assets and liabilities due to the November 1967 devaluation.

Table XVI–5

GROSS INTERSECTORIAL CREDIT FLOWS, 1966–67[a]

(IL million)

Lending sector \ Borrowing sector	Public sector	Public sector companies	Nonprofit institutions	Private business	House-holds	Total credit to sectors with a demand surplus	Rest of the world	Banking system	Social insurance funds and insurance companies	Financial institutions	Total credit granted
Public-sector											
1966	××	303	31	131	191	656	353	–86	7	105	1,035
1967	××	449	20	153	228	850	628	435	17	214	2,144
Public sector companies											
1966	37	××	—	46	46	129	68	13	1	10	221
1967	42	××	—	53	53	148	130	46	4	20	348
Nonprofit institutions											
1966	2	—	××	4	6	12	—	–1	—	3	14
1967	19	—	××	4	6	29	—	37	—	—	66
Private business											
1966	145	23	8	××	[b]	176	165	28	27	17	413
1967	131	17	14	××	[b]	162	255	100	25	46	588
Households											
1966	247	22	10	[b]	××	279	28[c]	628	338	28	1,301
1967	344	17	16	[b]	××	377	25[c]	660	370	22	1,454
Rest of the world											
1966	845	2	—	108	[b]	955	××	69	—	134	1,158
1967	1,091	45	—	161	[b]	1,297	××	187	—	71	1,555

Banking system											
1966	161	19	24	471	7	682	-1	××	—	84	765
1967	1,030	34	24	77	-31	1,134	408	××	1	122	1,665
Social insurance funds and insurance companies											
1966	87	21	14	21	21	164	4	63	××	159	390
1967	177	24	8	22	-7	224	—	57	××	145	426
Financial institutions											
1966	244	30	—	178	80	532	1	42	3	××	578
1967	286	30	—	162	56	534	11	106	-1	××	650
Total credit received											
1966	1,768	420	87	959	351	3,585	618	756	376	540	5,875
1967	3,120	616	82	632	305	4,755	1,457	1,628	416	640	8,896
Errors and omissions[d]											
1966	-6	—	2	-102			87	3	-13	29	—
1967	19	-3	12	-402			355	35	-9	-7	—

[a] The figures for 1966 have been revised. In 1967 transactions with the rest of the world were recorded at IL 3.06/$ 1. Devaluation differentials accruing as a result of the November 1967 devaluation are not regarded as credit flows. In this year's Report two types of credit flows are treated differently: (1) Bill brokerage transactions are represented as a flow between households and the banking system and between the latter and business firms. (2) The absorption of funds through open-market operations is recorded as a reduction of credit from the banking system to the sectors purchasing securities in the open market.

[b] No data are available on credit flows between these sectors.

[c] Incomplete data—purchases of foreign securities.

[d] The errors and omissions in the rest-of-the-world column are identical with the net errors and omissions in the country's balance of international payments.

Table XVI–6
NET INTERSECTORIAL CREDIT FLOWS, 1966–67[a]
(IL million)

Borrowing sector / Lending sector	Public sector	Public sector companies	Nonprofit institutions	Private business	House-holds	Total credit to sectors with a demand surplus	Rest of the world	Banking system	Social insurance funds and insurance companies	Financial institutions	Total credit granted
Public sector											
1966	××	266	29	—	—	295	—	—	—	—	295
1967	××	407	1	22	—	430	—	—	—	—	430
Public sector companies											
1966	—	××	—	23	24	47	66	—	—	—	113
1967	—	××	—	36	36	72	85	12	—	—	169
Nonprofit institutions											
1966	—	—	××	—	—	—	—	—	—	3	3
1967	—	—	××	—	—	—	—	13	—	—	13
Private business											
1966	14	—	4	××	[b]	18	57	—	6	—	81
1967	—	—	10	××	[b]	10	94	23	3	—	130
Households											
1966	56	—	4	[b]	××	60	28[c]	621	317	—	1,026
1967	116	—	10	[b]	××	126	25[c]	691	377	—	1,219
Rest of the world											
1966	492	—	—	—	[b]	492	××	70	—	133	695
1967	463	—	—	—	[b]	463	××	—	—	60	523

Banking system											
1966	247	6	25	443	—	721	—	××	—	42	763
1967	595	—	—	—	—	595	221	××	—	16	832
Social insurance funds and insurance companies											
1966	80	20	14	—	—	114	4	63	××	156	337
1967	160	20	8	—	—	188	—	56	××	146	390
Financial institutions											
1966	139	20	—	161	52	372	—	—	—	××	372
1967	72	10	—	116	34	232	—	—	—	××	232
Total credit received											
1966	1,028	312	76	627	76	2,119	155	754	323	334	3,685
1967	1,406	437	29	174	70	2,116	425	795	380	222	3,938
Errors and omissions[d]											
1966	–6	—	2	–102			87	3	–13	29	—
1967	19	–3	12	–402			355	35	–9	–7	—

[a] The figures for 1966 have been revised. In 1967 transactions with the rest of the world were recorded at IL 3.06/$ 1. Devaluation differentials accruing as a result of the November 1967 devaluation are not regarded as credit flows. In this year's Report two types of credit flows are treated differently: (1) Bill brokerage transactions are represented as a flow between households and the banking system and between the latter and business firms. (2) The absorption of funds through open-market operations is recorded as a reduction of credit from the banking system to the sectors purchasing securities in the open market.

[b] No data are available on credit flows between these sectors.

[c] Incomplete data—purchases of foreign securities.

[d] The errors and omissions in the rest-of-the-world column are identical with the net errors and omissions in the country's balance of international payments.

credit from business firms in the form of severance-pay reserve accumulation and grant them credit as part of their approved investments. The magnitude of the separate gross flows is of interest, but in order to clarify the relationships between sectors, it is necessary to offset the credit outflow against the credit inflow of each pair of sectors. One sector makes funds available to another not only by giving new loans, but also by repaying loans received, and this is reflected in the gross credit-flows structure.

The credit flows (shown in Tables XVI–5 and XVI–6) should be analyzed with caution, particularly in drawing conclusions about the private sector and the two component segments, because of the magnitude of the errors and omissions item in the country's balance of payments and because of the possibility that there were big unidentified changes in 1966 in the credit flows between business firms and households. Following are the main developments in the credit-flows system in 1966 and 1967.

(a) *Households*

In 1966 the amount of gross credit provided by households to the financial and real sectors remained unchanged, following a conspicuous rise the year before.

The behavior of households in stepping up purchases of financial assets was symptomatic of the transition from a period of economic growth to one of recession. The preference for financial over real assets does not appear to have intensified in 1967, nor was there any marked change in the sectorial destination of gross household credit, whose principal recipients continued to be the banking system, social insurance funds, insurance companies, and the public sector.

The composition of household credit to the banking system changed drastically in 1967: the outstanding balance of bills bought through banks (bill brokerage credit) fell by a steep IL 279 million, while fixed-term deposits in saving schemes and Pazak and Tamam accounts increased considerably, and demand deposits and cash holdings also rose. The shift from bill brokerage to deposits can largely be attributed to the crisis in the banking industry that occurred at the beginning of the year.

Household contributions to social insurance funds are the chief form of contractual saving in Israel, and changes therein are primarily a function of developments in employment, wages, and fringe benefits, rather than saving habits.[1]

Household credit to the public sector jumped from IL 247 million in 1966 to IL 344 million, chiefly because the Government stepped up its bond issues.[2]

[1] The reasons why these contributions grew in 1967 despite wage stability are discussed in Chapter XVIII, "Social Insurance Funds and Insurance Companies".

[2] Government bonds include the Absorption and Defense Loans, the purchase of which is not motivated by ordinary investment considerations. Moreover, household savings indirectly increased Development Loan issues, since part of the investment of the social insurance funds and banks (from saving scheme funds) is made in these securities (see Chapter XX, "The Securities Market").

At the end of 1966 the Short-Term Loan ceased to be a means of financing Government activity, and instead it became an instrument of monetary policy, designed to influence liquidity in the economy. This affected its treatment in the credit-flows structure, even though it made no difference to the households buying the loan.[1]

Gross credit received by households from the public sector rose, a reflection of the Government's endeavor to encourage building activity by easing credit terms to home buyers. The net credit flow from households to the public sector nevertheless expanded from IL 56 million in 1966 to IL 116 million in the year reviewed.

The shift from real to financial saving is reflected in the smaller amount of gross credit received by households from financial institutions (particularly mortgage banks) in 1967. In 1966 this item stayed at the previous year's level, apparently because the decline in housing purchases was offset by an increase in the average size of the mortgage loans.[2]

(b) *Business enterprises*

The outstanding change in the business sector was the curtailment of credit from the banking system. In 1966 financing from this source had risen from IL 259 million the year before to IL 471 million, a somewhat surprising development in a year of declining business activity. Two explanations may be offered. First, demand for credit went up in 1966 as a direct result of the recession: the weakening of aggregate demand forced firms to finance involuntary stockpiling and grant more customer credit, and they had greater recourse to banks and the bill brokerage market. Second, the 1966 figures are probably overstated owing to the inclusion of bill brokerage credit received by other sectors (particularly local authorities, nonprofit institutions, and public sector companies), which could not be segregated in the available data.[3]

In 1967 bank credit to business enterprises came to IL 77 million, considerably less than in years of vigorous economic activity. This can be attributed to two factors. One is that, in contrast to 1966, the low level of activity was accompanied by the running-down of inventories. The second reason is connected with credit flows between households and business—no data are available on such flows and their direction is conjectural. In 1967 households may have repaid some of the net

[1] In Table XVI–5 the change in the function of the Short-Term Loan is reflected by a decrease of IL 26 million in the amount of credit received by the private sector from the banking system in 1966 and by IL 108 million in 1967. Until November 1966 sales of the loan were recorded as credit granted by the private to the public sector. If it were not for this change, incremental purchases of Government securities in 1967 would have been IL 82 million higher.

[2] See Chapter XVII, "Financial Institutions".

[3] The order of magnitude of this bias is about IL 100 million (see Bank of Israel Annual Report for 1966, p. 412, note 2).

credit they received from businesses in 1966, which presumably was stepped up considerably. These repayments may have provided some of the additional financing required in 1967, so that there was no need to borrow more heavily from the banking system, or they may have been applied to redeeming part of the debt to banking institutions incurred in 1966.[1]

In 1967 business holdings of cash and demand deposits grew by about IL 100 million as a direct outcome of the large monetary expansion of 1967. In Table XVI–5 the incremental holdings are reflected in the growth of credit granted by business firms to the banking system.[2]

Credit from businesses to the public sector dropped slightly in 1967. This was a resultant of the repayment of short-term credit by the National Institutions and local authorities and the granting of credit through purchases of the Defense Loan.[3]

The small rise in long-term credit received by businesses from the public sector only slightly reflects the public sector's attempts to encourage economic activity. This is because most of the public sector's influence in this direction lies in its intervention in the allocation of credit by the financial sectors.

Table XVI–5 shows an increase in credit by business to the rest of the world, but the data are not very reliable and consequently no conclusions can be drawn from them.[4]

(c) *Public sector*

Both gross and net credit received by the public sector from the banking system and gross credit from abroad grew appreciably in 1967, and were the principal sources of the year's large monetary expansion. The public sector's willingness to finance such a large percentage of its operations in a manner increasing the economy's liquidity is explained by the recession and the unemployment prevailing in the first half of 1967. In these circumstances, an increase in public sector operations accompanied by monetary expansion has a stimulative effect on economic activity, but does not create inflationary pressures.

The influence of the public sector's financing methods can be illustrated by examining what would have happened had the sector transferred to the Bank

[1] If these conjectures are correct, the demand surplus picture of Table XVI–3 would be different: the household supply surplus would rise less in 1966 and more in 1967 than shown in the table, while the business demand surplus would decline less in 1966 and more in 1967.

[2] The incremental holdings should not be regarded as a conventional credit operation, owing to the passive role played by the "lender".

[3] In 1966 the National Institutions and local authorities received short-term credit from the business sector, mainly in the form of supplier credit.

[4] Since the private sector flows are obtained as residuals, the estimate of flows between the business and the rest-of-the-world sectors is greatly affected by the errors and omissions item of the country's balance of payments.

of Israel the short-term deposits it held abroad. Such a shift would have reduced the public sector's net credit from the Bank of Israel and increased its net credit from abroad, both by IL 300 million.[1] The data would then have shown that net bank credit to the public sector did not rise in 1967, and that the growth of the demand surplus was financed from foreign sources. However, since the expansionary effect of an increase in bank credit is identical with that of an increase in foreign receipts, our conclusions are not affected by the changed method of recording the flows.

The financing of the public sector by the banking system and the rest-of-the-world sector can be understood by examining the gross credit received from these two sectors and the depositing thereof with the Bank of Israel. Gross credit from the banking system rose from IL 161 million in 1966 to IL 1,030 million in 1967, most of the increase being in loans and advances. The larger amount of finance raised abroad resulted in an increase in public sector deposits with the Bank of Israel, and consequently in a decline in net bank credit.

It should be stressed that while the net credit outflow to the nonfinancial sectors held steady in 1967, this was the resultant of an increase in both the amount of funds mobilized by the public sector and the amount lent to the rest of the economy. In other words, the public sector's financial mediation was on a much larger scale in the year reviewed.

(d) *Public sector companies*

In 1967 the public sector provided a much larger volume of gross and net credit to the public sector companies. The growth of credit exceeded that of the companies' demand surplus, and they were therefore able to lend to other sectors, chiefly in the form of debt repayment, credit to foreign customers, and increased deposits with and repayments to banking institutions.

(e) *Rest-of-the-world sector*

This sector provided more gross and net credit to the real domestic sectors in the year reviewed. The expansion of the country's foreign exchange reserves was reflected by a rise in net credit granted by the banking system to the rest of the world and in the public sector's deposits abroad; in 1966 the banking system had been a net recipient of credit from this source (i.e. foreign exchange reserves diminished).

The expansion of foreign exchange reserves mirrors the special nature of overseas capital mobilization in the year reviewed: the growth did not follow a rise in the import surplus—in 1967 the import surplus did not widen—but was an outcome of the public sector's fund-raising effort among World Jewry.

[1] The foreign currency balances with the Bank of Israel would also have risen by IL 300 million.

Financial institutions raised less capital abroad in 1967, apparently because of weakening domestic demand for credit.

Public sector companies repaid a considerable amount of foreign liabilities in 1967, but they also received new credit for the purchase of ships and aircraft.

(f) *The banking system*

Whereas in 1966 the banking system had granted more gross and net credit to the real domestic sectors (excluding the public sector), in 1967 it provided less. The changes in the credit demand of the various sectors have been discussed above. It should nevertheless be noted that the decrease in bank credit was accompanied by a change in its composition. The crisis that hit three of the banks at the beginning of the year deterred the public from investing in bill brokerage, and the banking institutions adapted themselves to this situation by attracting the funds leaving bill brokerage to time deposits and saving schemes and by granting credit out of their ordinary resources.

(g) *Social insurance funds and insurance companies*

The allocation of credit granted by the social insurance funds and insurance companies changed conspicuously in 1967: the share of the public sector rose as a result of its larger finance requirements, while the share of the other sectors fell owing to sagging demand.

(h) *Financial institutions*

The major sources of credit for the financial institutions continued to be the social insurance funds and insurance companies, the rest-of-the-world sector, and the banking institutions. As stated, the considerable volume of credit granted out of earmarked public sector deposits with financial institutions are treated as flowing directly from the public sector to the final borrowers. The financial institutions curtailed their lending in the year reviewed, apparently because of ebbing demand.