CHAPTER XVII

THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET

1. MAIN DEVELOPMENTS

The total amount of medium- and long-term resources mobilized by the financial intermediaries surveyed in this chapter declined in real terms in 1979. The decrease was most noticeable in the public's accumulation of financial assets and loan repayments. Nevertheless these two channels continued to provide the bulk of medium- and long-term funds. In the uses of the institutions' resources there was no real change in the amount of credit granted this year, but there was a sharp drop in secondary uses, such as transfers to the commercial banking system and short-term uses.

The real decline in medium- and long-term asset accumulation was a new development, which can only be understood if we examine some general factors that depressed saving this year and checked the growth of the public's financial portfolio. Prominent among these factors were certain cyclical and other influences that stimulated demand for durable goods and the hiking of interest rates on short-term credit, which made it less worthwhile to hold financial assets. Considering these factors, the downturn in medium- and long-term financial asset accumulation was relatively modest, thanks primarily to the increase in contractual contributions to social insurance funds, which are linked to wage and salary payments.

A number of changes occurred this year in the relative shares of the various types of medium- and long-term assets in total resource mobilization. The accumulation in social insurance funds, indexed long-term deposits, and life insurance rose, while the previous year's contraction of savings schemes and mutual funds was more pronounced in 1979. In 1979 too the public's securities transactions in new issues and on the secondary market did not constitute a net source of medium- and long-term funds, although its net sale of securities was smaller this year.

Medium- and long-term loan repayments also slumped this year in real terms, as payments on account of nonindexed loans received in the past lagged behind the

Table XVII-1

ESTIMATED MEDIUM- AND LONG-TERM FINANCIAL SOURCES AND USES, 1977-79
(IL billion)

	1977	1978	1979 Total	1979 First half	1979 Second half
Sources					
Accumulation of financial assets by the public[a]	8.2	16.7	24.5	15.0	9.5
Loan repayments[b]	10.3	15.0	22.0	9.9	12.1
Foreign sector[c]	2.2	4.2	4.6	1.4	3.2
Government[d]	1.5	8.6	4.5	-3.0	7.5
Bank of Israel[e]	0.2	-0.1	4.2	0.3	3.9
Unindentified sources[f]	1.6	-4.7	0.3	-1.4	1.7
Total	**24.0**	**39.7**	**60.1**	**22.2**	**37.9**
Uses					
Medium- and long-term credit[g]	17.5	28.1	51.6	19.8	31.8
Other uses, net[h]	6.5	11.6	8.5	2.4	6.1
Total	**24.0**	**39.7**	**60.1**	**22.2**	**37.9**

[a] Includes securities transactions and deposits (see Table XVII-2, line 7).
[b] To the system of capital market intermediaries and the government (see Table XVII-6, line 2, and Table XVII-9, line 5).
[c] Through deposits in commercial banks earmarked for medium- and long-term credit, and not foreign transactions of the system (see Table XVII-3 and Table XVII-6, line 3b).
[d] Net transfers from the government for financial uses (see Table XVII-9, line 7).
[e] Through net purchases of government bonds from new issues and in the secondary market, and net purchases from the frozen savings schemes portfolio; according to data of the State Loans Administration (see Table XVII-6, line 3c).
[f] The difference between total uses and total sources as listed above.
[g] See Table XVII-3.
[h] Includes other net uses of the system (Table XVII-6, lines 3a, 3d, 6b, 7, 8, 9) and use of proceeds from securities transactions other than by financial institutions or the government. The latter item amounted to IL2.3 billion, IL4.6 billion, and IL1.2 billion in 1977, 1978, and 1979 respectively.

advance of prices. Among secondary sources the most striking development was a decline in total government transfers to the capital market institutions. The Bank of Israel provided more funds this year through its bond operations, but all told, the contribution of the capital market's financial operations to the monetary expansion fell off in real terms.

The real level of medium- and long-term credit held steady this year, with the amount supplied to the services rising and industrial credit and mortgage loans declining. Since investment expanded in 1979, the proportion financed by medium- and long-term borrowed funds sagged for the second year in a row. This was due partly to the modification of credit policy and partly to other factors, such as changes in the composition of investment.

Since less short-term credit was available this year, the drop in the credit-investment ratio caused difficulties in investment financing. At the same time there was no apparent reduction in the subsidization of investment, as the gap widened this year between the inflation rate and the nonindexed interest rate at which most medium- and long-term credit had been extended.

The development of medium- and long-term sources and uses did not trace an even path in 1979. Savings dipped sharply in the second half, while credit and transfers for short-term uses expanded. These developments, a reaction to the monetary squeeze, contributed to the sharply higher government liquidity injection in the second half.

It was decided this year to link investment loans and mortgages to the consumer price index or to the dollar. In principle, this decision paves the way for reforming the capital market, achieving a more efficient allocation of the economy's resources, and preventing inflationary capital gains. However, the full benefit of this step apparently cannot be reaped under the present system of taxation, and there is even reason to believe that in certain cases it will have an undesirable effect.

I. OVERALL ANALYSIS

1. INTRODUCTION[1]

This chapter deals with the mobilization of medium- and long-term funds and their allocation to different uses, especially the financing of investment. It does not deal with all medium- and long-term financial flows, but concentrates on those generated by financial and banking institutions and the government through its financial intermediation.[2]

The main primary sources of funds of the system of institutions surveyed here are the net accumulation of medium- and long-term savings of the public, net purchases of securities for direct holdings, and medium- and long-term loan repay-

[1] Two additional changes were made this year with a view to achieving a more comprehensive presentation of medium- and long-term financial flows: (a) The total amount of capital raised from the sale of domestic tradable securities to the public has been incorporated in the system's sources and uses. (b) The institutional framework has been broadened to include the medium- and long-term activities of the system of financial intermediaries and the government, earmarked foreign currency deposits in commercial banks, and the proceeds from the sale of securities. On the other hand, less emphasis is given to a descriptionof the institutional arrangements and of the interrelationship between the various institutional frameworks. On this point see the relevant chapter in previous Annual Reports.

[2] This chapter does not incorporate (or it only partly incorporates) the following medium- and long-term flows: (a) direct capital mobilization by the nonfinancial private sector and the nongovernmental public sector in Israel and abroad (except for the sale of securities to the public as defined in Chapter XVIII); (b) the government's transactions with the foreign sector (these are discussed only in the section dealing with government activities; and (c) grants.

ments to financial institutions and the government. These sources are supplemented chiefly by loans obtained abroad through financial institutions (mostly deposits for loan purposes) and net government transfers from other surplus foreign currency receipts.[3]

The public's medium- and long-term asset accumulation is effected chiefly through savings in primary financial intermediaries, such as social insurance funds and savings schemes. In most cases the funds obtained from this and other sources do not flow directly to their final destinations, but pass through a multistage intermediation process involving financial and banking institutions and the government.[4] In the final analysis, the funds are used for providing medium- and long-term credit for dwelling and nondwelling investment. Among the remaining destinations the most important are certain short-term uses, such as transfers to the commercial banking system.

In the mobilizing and onlending of medium- and long-term funds three principal institutional frameworks can be distinguished:

(a) The system of capital market intermediaries, which comprises financial and banking institutions engaging predominantly in medium- and long- intermediation, mutual funds, and those segments of the commercial banking system which specialize in the raising and allocation of medium- and long-term funds (such as savings schemes and linked long-term deposits).

(b) The government's financial intermediation.

(c) The provision of medium- and long-term foreign currency credit from earmarked deposits in commercial banks.

Most transactions with the public are carried out through the first of these frameworks. Nevertheless the government decisively influences the entire process of mobilizing and allocating funds and their terms (see below).From the macroeconomic aspect it does not seem particularly useful to break down these activities according to formal institutional framework, and so a major part of this survey is devoted to an overview of the entire system.[5]

The lion's share of the public's medium- and long-term savings is in value-linked channels guaranteeing a real positive return. On the other hand, the bulk of the medium- and long-term credit was until recently granted on a nonindexed basis

[3] The reference is to funds that do not originate in the medium- and long-term domestic financial activities of the government (which are discussed in this chapter). Broadly, the government's surplus receipts from its transactions with the foreign sector and its short-term domestic financial activities are used to finance the government's demand surplus and the net outflow in connection with its medium- and long-term domestic financial transactions.

[4] The dimensions of this intermediation can be seen in Table XVII-8.

[5] A general presentation along these lines may be found in Table XVII-1 and in some of the other tables (see also note 1). A full statistical basis for Table XVII-1 has not yet been worked out, as is evident from the relatively large unidentified item.

and at a nominal interest rate well below the expected rate of inflation. This differential between the real interest rate guaranteed savers and the negative real interest rate paid by investors, whose financing was borne by the government, reflected from the start a deliberate policy of promoting savings and investment. But the steady exacerbation of inflation throughout the 1970s, accompanied by an only partial adjustment of nominal interest rates on credit, sharply depressed real interest rates from the borrower's point of view, and left him a tidy capital gain, most of it unexpected. This strongly affected the distribution of wealth and income, in a way not necessarily according with the declared order of priorities of Israeli society. Furthermore, the high negative real borrowing rate undoubtedly led to serious distortions in factor allocation. Needless to say, these conditions inhibited the development of a private capital market, contrary to the general view that government intervention in the economy should diminish once the stage of rapid development was over.

Opinion has been divided over the years whether to narrow the differential between the interest rate to savers and that to borrowers by the deindexation of savings or the indexation of loans.[6] After a start in the latter direction in 1978, it was decided in 1979 to link loans almost in full to the consumer price index or to the dollar. As explained below, the present system of taxing nominal profits and expenses is liable to erase some of the advantages inherent in this major change. Nevertheless loan linkage is unquestionably the correct basic solution; it is only necessary to eliminate the distortions arising from the tax system through an appropriate reform.

2. MEDIUM- AND LONG-TERM SOURCES AND USES

In 1979 the amount of medium- and long-term funds raised by the capital market intermediaries from their principal sources shrank in real terms. Asset accumulation by the public was up 47 percent nominally to stand at IL24.5 billion, compared with IL16.7 billion last year and IL8.2 billion in 1977 (see Table XVII-1). Medium- and long-term loan repayments grew at a similar nominal rate and reached IL22 billion, as against IL15 billion in 1978 and IL10.3 billion in 1977. After adjusting for the rise in the consumer price index, there was an 11 percent decline this year in these two sources, following a 10 percent real increase in 1978.[7]

Secondary sources, principally the foreign sector, government, and Bank of Israel, provided IL13.6 billion net this year, as opposed to IL8 billion in 1978 and

[6] This subject is related, among other things, to the divergence of views over the importance of the role which uncertainty plays and the causal relationship between the value-linkage devices and the aggravation of the inflationary process. (In many economies beset by inflation higher than that which prevailed in Israel until the start of the 1970s, there is still a strong reluctance to introduce value-linkage arrangements.)

[7] Deflated semiannually.

IL5.5 billion in 1977.[8] These are mainly supplementary sources which bridge the gap between the government's investment finance commitments and the funds originating in asset accumulation and loan repayment.

The strong uptrend in the procurement of funds abroad by the financial system tailed off this year at IL4.6 billion.[9] The amount transferred by the government for financing medium- and long-term activity, which reflects the capital market's contribution to the government liquidity injection, fell from last year's record level of IL8.6 billion to IL4.7 billion. In contrast, a larger amount was transferred this year by the Bank of Israel through its bond operations.[10] The total contribution of the government and the Bank of Israel remained unchanged at about IL9 billion.

Among the medium- and long-term uses the high weight of the credit component stands out. Such finance soared 84 percent this year to reach IL51.6 billion, as contrasted with IL28.1 billion last year. In real terms, however, the level hardly changed, after it had sagged 5 percent in 1978 (see below). Other net uses fell even on a nominal basis, from IL11.6 billion in 1978 to IL8.5 billion. Included in this category are the use of share issue proceeds,[11] which shrank this year (see Chapter XVIII); operating expenses of the system of institutions; and the transfer of funds to the commercial banking system and for short-term uses (see Table XVII-6). The amount of funds flowing from the system to the last two destinations declined this year in real terms. This was connected with the smaller supply of freely loanable funds at the disposal of the banking system this year because of the smaller amount mobilized and the increased proportion raised through social insurance funds, which supply less freely loanable resources than do savings schemes.

A glance at Table XVII-1 shows an uneven pattern in the development of sources and uses as between the two halves of the year. In the first half the total amount of medium- and long-term funds obtained through asset accumulation and credit repayment exceeded the total credit outflow and other net uses. The contribution of the secondary sources was thus negative; in particular, the government absorbed resources through its capital market operations. The second half of the year witnessed a nominal decline in asset accumulation and a relatively modest rise in repayments. At the same time, there was a rapid increase in the medium- and long-term credit outflow and in transfers by the capital market intermediaries to

[8] These data must be treated cautiously, since they include a residual component which fluctuates widely from year to year. It probably consists mostly of medium- and long-term deposit flows between the government and institutions not included in the capital market system surveyed here.

[9] This consisted chiefly of earmarked foreign currency deposits in commercial banks (see Table XVII-3) and funds mobilized abroad by the capital market intermediaries (see Table XVII-6).

[10] These transfers included IL3.3 billion of bonds purchased from original issues and in the secondary market and IL900 million net purchases from the frozen savings scheme portfolio. The purchase of bonds in the secondary market took place at the end of the year, and was intended to prevent too sharp a reaction by the market to the prevailing jitters and to the tight monetary policy introduced at that time.

[11] The reference is to share issues other than by the capital market intermediaries.

the banking system and for short-term uses. The developments, which were related to the monetary contraction at the time, led to a much larger liquidity injection by the government and the Bank of Israel through their capital market activities.

3. ASSET ACCUMULATION AND LOAN REPAYMENT

(a) Medium- and Long-Term Asset Accumulation

In 1979, as stated, the amount of medium- and long-term funds procured from the accumulation of financial assets[12] declined 7 percent in real terms, after real increases of 30 percent in 1978 and 155 percent in 1977. The contraction did not proceed at an even pace during the year: in the first half the level moved up 29 percent in real terms, but plummeted 57 percent in the second half (see Table XVII-2).

This decline must be viewed in conjunction with general developments in savings and the public's financial portfolio. Savings dipped 19 percent this year, owing largely to cyclical and other factors which stimulated purchases of durable goods. Such purchases were made at the expense of financial asset accumulation, which had shot up at an exceptional rate in the two preceding years. The slackening of demand for financial assets can also be attributed to a cut in the real volume of bank credit and a rise in its interest rate—a result of the policy of monetary contraction and of the absorptive effect of the oil price hike.

Against this backdrop the real decline in medium- and long-term asset accumulation does not appear so large. It slumped less than savings in general (7 vs. 19 percent) and much less than short-term financial asset accumulation.[13] This differential development must apparently be ascribed, first and foremost, to the stabilizing influence of "hard-core" contractual saving in some of the social insurance funds and life insurance. A comparison of medium- and long-term with short-term assets highlights the shrinkage of Patam accounts, after the initial rush to this new type of asset in 1978.

An examination of the composition of medium- and long-term assets accumulated in 1979 reveals that the weight of social insurance funds grew significantly, from 42 percent of the net total in 1978 to 58 percent this year. In real terms the accumulation in these funds rose 16 percent, a bit lower than last year's 19 percent gain. This development can largely be attributed to the contractual con-

[12] Assets are classified here as medium- and long-term to the extent that they supply to the issuers guaranteed resources for such periods. This does not necessarily mean that these assets are regarded as medium- or long-term by the holder (though this certainly applies to social insurance funds, savings schemes, and life insurance).

[13] According to a rough estimate the accumulation through Patam (Israel residents' foreign currency deposits), restitution accounts, money balances, time deposits in Israeli currency, and negotiable certificates of deposit dropped from some IL27 billion in 1978 to about IL3 billion in 1979. As opposed to this, medium- and long-term asset accumulation grew nominally from IL16.7 billion last year to IL24.5 billion in 1979.

Table

MEDIUM- AND LONG-TERM

(Flows of funds,

	1977	1978	1979 Total	1979 First half	1979 Second half
1. Social insurance funds, net[b]	3,850	6,940	14,110	5,990	8,120
2. Approved savings schemes, net[b,c]	5,730	7,610[d]	7,920	5,020	2,900
3. Mutual funds, net[b]	1,510	1,290	-3,030	950	-3,980
4. Life insurance, net[b]	870	1,470	2,880	1,070	1,810
5. Linked long-term bank deposits	390	1,170	3,270	1,330	1,940
6. Net purchase securities from original issues and in secondary market[e]	-4,160	-1,806[f]	-670	620	-1,290
6a. Thereof: Through the system[d,e]	-1,880	-4,050[f]	-4,480	-2,950	-1,530
7. Total accumulation in medium- and long-term channels (1 to 6)	**8,190**	**16,680**	**24,480**	**14,980**	**9,500**
8. Thereof: Through the system (1 to 5, 6a)	**10,470**	**14,430**	**20,670**	**11,410**	**9,260**

[a] Deflated semiannually by the consumer price index.

[b] Deposits (or premiums), less withdrawals of principal, interest, linkage differentials, and dividends (or claims).

[c] Savings schemes administered by commercial banks, mortgage banks, and other financial institutions.

XVII-2

SAVINGS BY THE PUBLIC, 1977-79

in IL million)

Percent annual nominal increase					Percent annual real increase[a]				
		1979					1979		
1977	1978	Total	First half	Second half	1977	1978	Total	First half	Second half
78	80	103	73	36	32	19	16	20	-7
113	33	4	32	-42	67	-7	-37	-10	-61
13	-15	-335	47	-519	-13	-51	-204	13	-383
40	69	103	51	69	4	14	7	0	15
200	200	179	127	46	112	106	58	58	0
244	**104**	**47**	**80**	**-37**	**155**	**30**	**-7**	**29**	**-57**
68	**38**	**44**	**59**	**-19**	**24**	**-10**	**-13**	**12**	**-45**

[d] Net sale of securities by the public in the secondary market, plus purchase of original issue securities deposited with the system, less redemption of securities by the system.

[e] Mainly government bonds and shares; includes a small amount of deposits in the system which are not included in items 1-5.

[f] Revised data.

tributions, which are related to wage and salary payments. Such contributions continued to expand within the framework of the labor agreements (see below). In contrast, there was a real decline in voluntary contributions in bank-administered provident funds.

The downswing in accumulated savings scheme deposits sharpened this year, from 7 percent in 1978 to 37 percent. The drop in the weight of this asset in total medium- and long-term accumulation (from 70 percent in 1977 to 32 percent in 1979) reflected its diminished attraction in comparison with alternative indexed assets—social insurance funds and direct bond holdings. There were two main reasons for this: (a) social insurance funds have become more liquid; and (b) the yield differential between savings schemes and bonds held for their entire life apparently does not compensate for the difference in their liquidity. Under these circumstances, when the savings schemes that were offered in 1973-74 reached maturity, some took advantage of this and turned to other assets.

Savings in the form of life insurance (see below) and long-term indexed deposits in commercial banks continued to expand in real terms. The latter is a relatively new instrument, which offers large depositors index-linkage terms for a relatively short average period of two and a half years. The real volume of such deposits rose 58 percent in 1979, compared with 106 percent last year. On the other hand, savings through mutual funds fell off in 1979 (see Chapter XVIII).

The net accumulation through the purchase of securities from original issues or in the secondary market remained negative in 1979. However, for the second consecutive year there was a decline in net sales of such securities, which consist mostly of stocks and government bonds. This item displayed a markedly different development between the two halves of the year, owing mainly to fluctuations in bond demand. The first half saw a buoyant demand, while in the second half the public unloaded part of its holdings due to fears that measures would be taken to impair their terms, and also because some companies ran into liquidity problems. Capital market institutions and the Bank of Israel absorbed some of the public's offerings in this period.

The shift in the past two years from a negative to a positve accumulation through directly-held government bonds reduced the role of the capital market intermediaries in total resource mobilization from the public. Nevertheless, their share remained at 85 percent.

(b) **Loan Repayments**

The real growth of this item is a function of the timing and original terms of the loans and changes in the inflation rate (most loans given in the past were not indexed). This year loan repayments were up 47 percent nominally; since this fell short of the rate of inflation, in real terms the level sank 13 percent, after a 4 percent drop in 1978. Despite the indexation of loans, this downtrend will probably persist in the next few years, since the share of indexed loans in the total stock is still small and repayment periods have been extended since 1978.

4. MEDIUM- AND LONG-TERM CREDIT

Medium- and long-term credit rose 84 percent in 1979, reaching IL51.6 billion (see Tables XVII-3 and XVII-4). But after adjusting for the annual average rise in the price of its uses, the real level held virtually steady, after a 5 percent drop the year before. Thus the lagging of credit behind investment, the main use of such finance, continued for the second year in a row.

The reason for this development probably should not be sought in the relative cost of medium- and long-term credit in comparison with alternative sources of financing. While the terms of medium- and long-term credit were altered this year (see below), this did not affect the majority of the investments implemented in 1979. In any case, the cost of such financing under the new terms was still lower than that of nondirected short-term credit or the realization of financial assets. For those investors who were still able to obtain medium- and long-term borrowed capital under the old terms, there was undoubtedly an additional relative drop in the cost of such finance this year in comparison with alternative sources of short-term credit: on the one hand the adjustment of interest rates on medium- and long-term credit failed to keep pace with the accelerated rise in prices, and on the other hand there was a real increase in the interest rate on nondirected short-term credit.

It therefore seems that the lagging of medium- and long-term credit behind the growth of investment lay primarily in the restriction of its supply. There were three factors working in this direction:

(a) The rate of financing of approved investments was cut, by the almost total termination of supplementary funding, the granting of which is not covered in the Law of the Encouragement of Capital Investments (as is the granting of development loans). In addition, mortgage financing shrank relative to dwelling prices (see Chapter VIII).

(b) The weight of approved projects in total investments fell, and the provision of development loans for nonapproved investments was discontinued.[14] The decline in the share of approved loans is apparently explained primarily by the cyclical upswing in low-priority investments in a period of renewed economic growth.

[14] No direct data are available on the total amount of approved investments implemented, but in the last three years there was a striking decline in the ratio between the approval of investments and total actual investment (either currently compared or lagged one year). This occurred despite the broadening of the definition of approved investments after the termination of developments loans for nonapproved investments.

Table

MEDIUM- AND LONG-TERM

(IL million,

	Total credit	Credit to households: Total	Mortgage credit: Directed	Mortgage credit: For private housing	Other credit
Through the capital market intermediaries					
1977	13,110	3,750	1,790	590	1,370
1978	19,800	5,820	2,900	1,090	1,830
1979					
Total	38,630	11,820	6,150	1,410	4,260
First half	14,920	4,760	2,465	705	1,590
Second half	23,710	7,060	3,685	705	2,670
By the government, other than through the system narrowly-defined					
1977	2,420	410			410
1978	4,330	790			740
1979					
Total	7,480	790			790
First half	2,840	320			320
Second half	4,640	470			470
From earmarked foreign currency deposits in commercial banks					
1977	2,000				
1978	4,000				
1979					
Total	5,480				
First half	2,025				
Second half	3,455				
Total					
1977	17,530	4,160	1,790	590	1,780
1978	28,130	6,560	2,900	1,090	2,570
1979					
Total	51,590	12,610	6,150	1,410	5,050
First half	19,785	5,080	2,465	705	1,910
Second half	31,805	7,530	3,685	705	3,140

XVII-3

CREDIT BY DESTINATION, 1977-79
at current prices)

	Credit to producing and service sectors					
Total	Industry	Agri-culture	Construc-tion	Services	Credit to local authorities	Credit to National Institutions[a]
8,030	3,700	1,170	460	2,700	1,330	
12,000	5,460	2,340	890	3,310	1,980	
22,670	9,280	5,250	1,620	6,520	4,140	
8,070	3,650	1,780	220	2,420	2,090	
14,600	5,630	3,470	1,400	4,100	2,050	
1,320	40	190	240	850	510	180
2,170	800	120	190	1,060	940	480
4,280	900	180	190	3,010	1,300	1,110
1,570	670	50	20	830	580	370
2,710	230	130	170	2,180	720	740
2,000[b]	500					
4,000[b]	1,000					
5,130	1,720	540	100	2,770	10	340
2,020	640	200	20	1,160	5	
3,110	1,080	340	80	1,610	5	340
11,350[b]	4,240	1,360	700	3,550	1,840	180
18,170[b]	7,260	2,460	1,080	4,370	2,920	480
32,080	11,900	5,970	1,910	12,300	5,450	1,450
11,660	4,960	2,030	260	4,410	2,675	370
20,420	6,940	3,940	1,650	7,890	2,775	1,080

[a] The National Institutions constitute a source of funds for the system of capital market intermediaries narrowly defined, and hence are not included among the recipients of credit in this framework.
[b] No sectoral breakdown of credit is available for 1977 and 1978.

Table XVII-4

GROWTH OF MEDIUM- AND LONG-TERM CREDIT, 1977-79
(Percentages)

		Credit to households				To producing and service sectors						
			Mortgage credit								To local	To
	Total credit	Total	Directed	For private housing	Other credit	Total	Industry	Agri-culture	Con-struction	Services	autho-rities	National Institutions
Nominal rates of change[a]												
1978	60.5	57.7	62.0	84.7	44.4	60.1	71.2	80.9	54.3	23.1	58.7	166.7
1979												
Total	83.4	92.2	112.1	29.4	96.5	76.6	63.9	142.7	76.9	181.5	86.6	202.1
First half	40.7	54.9	70.0	29.4	48.6	28.3	36.6	65.0	-51.9	101.8	83.2	54.2
Second half	60.8	48.2	49.5	0.0	64.4	75.1	39.9	94.1	534.6	78.9	3.7	191.9
Rate of change in prices												
1978	68.7[b]	67.2[b]	78.3[c]	78.3[c]	50.0[d]	69.5[b]	73.0[e]	60.0[e]		67.0[f]	67.0[g]	67.0[g]
1979	81.7[b]	109.1[b]	129.7[c]	129.7[c]	78.3[d]	70.0[b]	69.0[e]	76.0[e]		68.0[f]	91.0[g]	91.0[g]
Real rate of change												
1978	-4.9	-5.7	-9.1	3.6	-3.7	-5.5	-1.0	13.1		-26.3	-5.0	59.7
1979	0.9	-8.1	-7.7	-43.7	10.2	3.9	-3.0	37.9		67.6	-2.3	58.2

[a] The growth rates are biased downward, since a sectoral distribution of credit from earmarked deposits is not included in 1977 and 1978 (see the note to Table XVII-3).
[b] Index constructed from the weighted average of the credit granted to the relevant group, using 1979 weights.
[c] According to the housing price index, annual average.
[d] According to the consumer price index, annual average.
[e] Derived from constant-price investment data.
[f] Derived from constant-price investment data for services and electricity.
[g] According to the implicit deflator for public investments.
Source: Bank of Israel estimates.

(c) Since the credit is actually granted only some time after implementation of the investment, the acceleration of inflation is liable to depress the current ratio between credit and investment.

At the same time less credit was available this year, and the subsidy component of investment loans rose under the terms applicable to the bulk of the investments. The net effect of these two changes was probably in the direction of a heavier subsidization of investments carried out under the old terms. In any case, the problem of bridging the gap between the cost of investment and the amount of medium- and long-term financing provided by the system of intermediaries grew more serious this year, precisely at a time when alternatives sources of funding grew more expensive. Part of this gap may have been bridged by a heavier resort to foreign supplier credit (the weight of imported equipment in fixed assets rose this year).

The amount of credit granted this year to the producing and services sectors reached IL32 billion, about 62 percent of the total medium- and long-term outflow. After adjusting for the rise of prices, there was a modest increase, after the level had held steady in 1978. Some IL12 billion was provided to the services sector, industry received a similar amount, while the remainder was divided between agriculture (approximately IL6 billion) and construction.

Lack of detailed data for previous years on the sectoral allocation of credit from earmarked foreign currency deposits precludes a precise estimate of the rate of increase in such credit by sector. But there was definitely a real increase this year in the amount supplied to the services and agriculture, and a real decrease in that to industry and construction. Most of the incremental credit to the services sector was apparently accounted for by public services. In construction the figure rose sharply in the second half of the year, when public building companies stepped up their operations.

Table XVII-5 compares total credit and grants given to the industrial sector and its investment activity. It will be seen that the average rate of industrial financing[15] fell in recent years, which was consistent with the aforementioned developments. However, it must be emphasized that a comparison of this sort involves numerous difficulties, which cast doubt on its significance. These difficulties are particularly noticeable in a similar comparison for agriculture. On the face of it, such a comparison points to an abundance of medium- and long-term finance[16] precisely at the time when a committee studying the subject claimed there was a shortage of

[15] The reference is to total medium- and long-term credit, and not just credit granted on concessionary terms.

[16] If we assume that the weight of agriculture in total credit from earmarked foreign currency deposits was similar in 1977-78 to its weight in 1979, and if we add to the credit some IL200 million a year in grants, we get a financing rate in excess of 100 percent, and which rises from year to year.

Table XVII-5

MEDIUM- AND LONG-TERM CREDIT, GRANTS, AND INDUSTRIAL INVESTMENT, 1977-79
(IL million)

	1977	1978	1979
1. Medium- and long-term credit	4,240	7,260	11,900
2. Grants and medium- and long-term credit	5,040	8,260	14,150
3. Investment	5,105	10,070	18,230
4. Credit as a percent of investment (1/3)	83	72	65
5. Grants and credit as a percent of investment (2/3)	99	82	78

Source: Line 1—Table XVII-3; line 3—Ministry of Finance.

such funds.[17] The two main factors that distort the calculations are probably the difficulty of isolating credit for investment in agriculture from total investment credit granted to this sector, and the difficulty of distinguishing between new loans and the renewal of earlier loans.

The new financing terms, as stated, affected only a small percentage of the investments this year. The partial information available so far indicates that only one-eighth of the directed credit to home buyers and one-fourth of that for industrial investment were granted on the new terms (or terms for the transitional period).

It is difficult to determine the net effect of this change on the worthwhileness of investment (see below). But various evidence suggests that borrowers are reluctant to accept credit on the stiffer terms.

Credit to households reached IL12.6 billion this year, roughly a quarter of the total. Most of this sum was for mortgages (in the main directed credit). Although this component shot up precipitously this year, it declined in real terms (measured in relation to dwelling prices), while nondwelling credit to households rose in real terms, a development consistent with the change in short-term credit terms.

5. GOVERNMENT INFLUENCE ON THE CAPITAL MARKET SYSTEM

The government intervenes to a high degree in the entire process of mobilizing and allocating medium- and long-term capital. Among other things, it determines the rate of return to savers, the interest rate for borrowers, and the criteria for granting credit. It also largely controls the fund-flows in the various stages of in-

[17] In addition, a short-term financing problem arose in agriculture due to the reduction of directed credit and the piling up of losses in business activity.

Table XVII-6

SOURCES AND USES OF MEDIUM- AND LONG-TERM FUNDS OF THE CAPITAL MARKET INTERMEDIARIES, 1977-79
(Gross flows, in IL million)

			1979		
	1977	1978	Total	First half	Second half
Sources					
1. Savings of the public	10,470	14,430	20,670	11,410	9,260
2. Loan repayments	9,810	14,390	21,290	9,600	11,690
a. By households	2,370	3,020	4,720	2,020	2,700
b. By business	6,180	8,940	12,700	5,860	6,840
c. By local authorities	1,260	2,430	3,870	1,720	2,150
3. Other sources	780	1,290	1,760	-300	2,060
a. National Institutions (net)	200	450	630	110	520
b. Foreign sector (net)[a]	190	250	-940	-600	-340
c. Bank of Israel (net)	—	—	900	—	900
d. Other	390	590	1,170	190	980
4. Total sources	**21,060**	**30,110**	**43,720**	**20,710**	**23,010**
Uses					
5. Total medium- and long-term credit	13,110	19,800	38,630	14,920	23,710
6. Net transfer of funds	4,500	4,850	-3,270	2,910	-6,180
a. To the government	3,130	2,310	-4,050	2,750	-6,800
b. To banking institutions	1,370	2,540	780	160	620
7. Net short-term uses (incl. currency and demand deposits)	1,980	1,280	2,430	260	2,170
8. Surplus of expenditure over income	2,180	4,470	6,630	2,880	3,750
9. Dividends and other net payments[b]	-710	-290	-700	-260	-440
10. Total uses	**21,060**	**30,110**	**43,720**	**20,710**	**23,010**

[a] Includes short-term transactions with the foreign sector.
[b] Mostly in connection with general insurance transactions.
Source: Bank of Israel estimates.

Table XVII-7

FLOW OF FUNDS BETWEEN THE SYSTEM AND THE GOVERNMENT AND BANKING INSTITUTIONS, 1977-79

(IL million)

		Long-term assets and liabilities[a]			Current long-term transactions[b]			
		Receipts o/a assets (1)	Payments o/a liabilities (2)	Surplus of receipts over payments (1-2) (3)	Receipts[a] (4)	Payments[b] (5)	Surplus of receipts over payments (4-5) (6)	Total surplus (3+6) (7)
Government	1977	8,130	1,230	6,900	4,920	14,950	-10,030	-3,130
	1978	19,400[c]	2,840	16,560[c]	8,910	27,780[c]	-18,870[c]	-2,310[c]
	1979							
	Total	30,750	4,580	26,170	16,410	38,530	-22,120	4,050
	First half	12,380	1,970	10,410	6,060	19,220	-13,160	-2,750
	Second half	18,370	2,610	15,760	10,350	19,310	-8,960	6,800
Banking institutions[d]	1977	350	1,440	-1,090	1,660	1,940	-280	-1,370
	1978	800[c]	1,420	-620[c]	2,950[c]	4,870[c]	-1,920[c]	-2,540[c]
	1979							
	Total	760	930	-170	10,490	11,100	-610	-780
	First half	230	740	-510	3,900	3,550	350	-160
	Second half	530	190	340	6,590	7,550	-960	-620

[a] Deposits, loans, and securities (including interest and linkage differentials received and paid). In the case of the government col. 1 consists mainly of repayments of past deposits by the Accountant General, and col. 2 of repayments of deposits of the Accountant General with the capital market intermediaries and Finance Ministry participation in savings scheme grants.

[b] Deposits, loans, and sales (and purchases) of securities. In the case of the government col. 4 consists mainly of sums redeposited by the government, and col. 5 of deposits of security issue proceeds.

[c] Revised datum.

[d] The commercial banking system, less medium- and long-term transactions included in the data on the capital market intermediaries.

Source: Bank of Israel estimates.

Table XVII-8

GROSS MEDIUM- AND LONG-TERM CREDIT AND CAPITAL MARKET TRANSACTIONS[a] OF THE SYSTEM, 1977-79
(IL million)

			1979		
	1977	1978	Total	1st half	2nd half
1. Intrasystem financial transactions	26,280	48,940	75,470	30,590	44,880
2. Receipts from other sectors	38,460	69,400	115,080	48,100	66,980
3. Total financial transactions (1+2)	64,740	118,340	190,550	78,690	111,860
4. Gross medium- and long-term credit	13,110	19,800	38,630	14,920	23,710
5. Ratio between gross credit and total transactions (3/4)	4.9	6.0	4.9	5.3	4.7

[a] Medium- and long-term financial transactions only.
Source: Bank of Israel estimates.

termediation. Government intervention in the setting of the borrowing and lending terms does not guarantee a balance between the supply of funds, in the main household savings, and the demand for them, which is chiefly influenced by the volume of domestic investment and the rate of financing. If a gap appears between total medium- and long-term sources and uses, the government acts to regulate the flows. Even now, after the spread between the price of capital mobilization and the price at which credit is granted has been significantly narrowed because of the indexation of directed loans, the government will continue to intervene in the capital market, transfering resources in order to cover the value-linkage imbalance on past transactions.

The funds transferred by the government to the capital market are derived from its various domestic financial activities (see Table XVII-9). The expansionary influence of the government's long-term financial activity is not measured only by the excess of uses over sources; account must also be taken of the subsidy component of its financial intermediation.

After adjusting for the rise in the consumer price index, there was a real 28 percent drop in 1979 in the gross amount of funds directly channeled by the government in its domestic financial transactions, as opposed to a real increase of 61 percent in 1978. This was largely a technical downswing, resulting from the renewal of the stock of bonds that reached maturity in 1978. These developments found expression in a real contraction of government payments on account of exchange rate and linkage insurance, since payment is made at the time the insured loans and bonds are redeemed, and not during the period of accrual.

Table XVII-9
DOMESTIC SOURCES AND USES OF FUNDS FOR THE GOVERNMENT'S MEDIUM- AND LONG-TERM FINANCIAL TRANSACTIONS,[a] 1977-79
(Gross flows, in IL million)

	1977	1978	1979 Total	1979 1st half	1979 2nd half
Sources					
1. Sale of government bonds[b] (voluntary)	2,030	12,260	22,780	12,610	10,170
2. Financial institution deposits of earmarked security issue proceeds	11,670	15,230	19,360	3,220	9,800
3. Commercial bank and financial institution deposits	1,350	4,120	4,970	3,230	1,750
4. Collection of matured deposits with financial institutions	950	2,770	3,860	1,650	2,210
5. Direct repayment of credit	450	570	750	300	450
6. Receipts on account of the government's securities portfolio (incl. sales of shares from the portfolio)	120	130	40	10	30
7. Surplus of sources over domestic uses	1,530	8,580	4,530	-2,980	7,510
Total domestic sources	**18,100**	**43,660**	**56,290**	**24,370**	**31,920**
Uses					
1. Redemption of government bonds	4,050	11,490	11,950	5,380	6,570
2. Repayment of financial institution deposits of earmarked security issue proceeds	4,480	9,940	9,900	5,180	4,720
3. Repayment of commercial bank and financial institution deposits of proceeds of other security issues	110	480	1,170	450	720
4. Grants on savings schemes (in place of interest)	—	470	910	340	570
5. Earmarked deposits in financial institutions	4,180	8,890	14,410	6,060	8,350
6. Credit provided directly	2,420	4,330	7,480	2,840	4,640
7. Purchase of shares and bonds	280	190	210	90	120
8. Net payments on account of exchange rate and linkage insurance	2,580	7,870	10,260	4,030	6,230
Total domestic uses	**18,100**	**43,660**	**56,290**	**24,370**	**31,920**

[a] Includes financial items amounting to IL3.7 billion, IL12.8 billion, and IL19 billion in 1977, 1978, and 1979 respectively, which are included in the government's domestic demand surplus (see Table X-3).

[b] Excludes compulsory loan receipts amounting to IL310 million, IL450 million, and IL2,540 million in 1977, 1978, and 1979 respectively.

Table XVII-10

SOURCES AND USES OF FUNDS FOR THE GOVERNMENT'S MEDIUM- AND LONG-TERM FINANCIAL TRANSACTIONS WITH THE FOREIGN SECTOR, 1977-79
(Gross flows, in IL million)

			1979		
	1977	1978	Total	First half	Second half
Loans from abroad					
Sale of Israel Bonds	3,010	6,250	9,480	3,910	5,570
Government and international institution loans[a]	270	15,350	23,910	8,360	5,550
Bank and other loans	3,920	760	4,130	1,050	3,080
Total sources from abroad	**7,200**	**22,360**	**27,520**	**13,320**	**14,200**
Repayment of foreign loans					
Israel Bonds	1,830	3,920	7,580	3,080	4,500
Government and international institution loans[a]	680	4,120	1,130	200	930
Bank and other loans	2,510	4,000	1,390	690	700
Surplus of foreign sources over uses	2,180	10,320	17,420	9,350	8,070
Total uses abroad	**7,200**	**22,360**	**27,520**	**13,320**	**14,200**

[a] Excludes U.S. government loans directly related to defense imports.

The excess of uses over domestic sources of funds totaled IL4.5 billion, compared with IL8.6 billion in 1978. The decline is partly explained by the larger net amount of capital mobilized by the government this year (this was only partly reflected in the public's accumulation due to net Bank of Israel security purchases in the secondary market), and by a real decrease in payments on account of exchange rate and linkage insurance. In addition, there was a further increase in net capital mobilization through the purchase of government bonds in lieu of financial institution deposits of the proceeds from earmarked and other security issues. This change was related primarily to the revision of the required coverage for some of the institutional savings media, and to a lesser degree to changes in the public's accumulation in these media.

The government's financial transactions with the foreign sector appear in Table XVII-10. Although the information is incomplete,[18] it points to a continued flow of funds from abroad to the government, to the tune of IL17 billion this year, as compared with IL10 billion in 1978. The surplus resources from abroad not only helped to fund the government's domestic financial transactions, but also served as an important source for financing the government's domestic demand surplus and its overseas purchases (see Table X-3).

[18] This table does not include the government's income from its financial assets abroad.

6. CHANGES IN MEDIUM- AND LONG-TERM CREDIT TERMS

Most of the credit provided by the system for medium and long terms is cheap credit granted in accordance with public sector directives. This applies in particular to funds supplied for financing investment in the producing sectors of the economy and to households for the purchase of homes. Only a small fraction of total medium- and long-term credit is given at the market rate of interest, to sectors or branches whose investments are not on the high-priority list, notably services. In 1979 the terms of directed credit were altered drastically as a result of the government's decision to link long-term credit to changes in the price level or the dollar. Nevertheless most of the development loans this year were still given according to the floating interest rate system introduced in 1978.[19] Under this system the interest rate was revised from time to time in accordance with changes in the pace of inflation, in contrast to the practice in the past, when the interest rate had been fixed for the entire repayment period. But under this system the interest rate was only partially adjusted to the pace of inflation and not continuously. Worst of all, the adjustment was made only for a maximum inflation rate of 40 percent.[20]

The floating interest rate regime was supposed to reduce the subsidy component of directed government credit, but the lag in adjusting the rate in the face of mounting inflation, together with the lengthening of the repayment period, in effect increased the subsidy element in these loans and made it necessary to revamp the terms of long-term credit. Against this background, and in the light of the government's declared aim of reducing its intervention in the capital market, a decision was made at the end of May 1979 to value-link development loans to the producing and service sectors as well as mortgage loans to households. Furthermore, in the case of applications already in the pipeline but not yet approved, the loans were to be partly indexed, while loans already approved but not yet granted were to carry the terms that prevailed at the time they were approved. New loans (i.e. which had not yet been requested at the time the change went into effect) were to be fully indexed, with an additional indexed interest charge of between 0.5 and 1.5 percentage points; alternatively, the loans could be fully linked to the dollar, with an added interest charge of 6-7.5 percentage points. With respect to loans in the process of approval, the following terms were fixed: 70 percent indexation with

[19] Besides development loans, there are two other ways in which the investor can receive directed credit: the leasing of equipment from specialized leasing companies, and overseas lines of credit managed mainly by the commercial banking system. The rate of financing provided under these arrangements is higher, but so too is the cost of credit. The weight of such credit in the total amount of funding has risen in recent years, but it still constitutes a small percentage of the total credit outflow to the producing and service sectors.

[20] The principal elements of the formula employed were a basic interest rate of 7-12 percent (depending on the location of the enterprise), plus half the expected annual inflation rate up to a ceiling of 40 percent. At the beginning of the year interest rates on development loans granted to industry and the tourist trade ranged between 22 and 27 percent, and on agricultural loans it stood at 24 percent. At the end of April the rates were hiked by another 5 percentage points.

additional interest (also 70 percent indexed) ranging between 0.5 and 2 points, depending on the regional location; or alternatively, full linkage to the dollar, with a similar extra interest charge. The option given to investors to choose the type of linkage, or any combination of the two alternatives, reduces his risk in that it enables him to choose a repayment schedule geared to the composition of this receipt flows.

The employment of the linkage device to control the real price of capital to the investor should result in a greater selectivity of investments beneficial to the economy as a whole, while achieving a more efficient allocation of the financial resources at the disposal of investors. This desirable goal depends on adapting the system of taxation to the prevailing inflationary conditions.

As long as the tax system is not revised, the consequences of loan linkage are unclear. Under the present system linkage differentials may be deducted for tax purposes at the time they are created (even if they are actually paid at a later stage). Thus investors can currently reduce their tax payments on account of accrued linkage differentials that will actually be paid at a later date. This is a major concession,[21] whose dimensions depend on the inflation rate, as in the case of unlinked loans. An additional feature of this concession is that the degree to which the investor takes advantage of it depends on the total amount of taxes he pays. It is therefore likely to be less significant to those whose total profits (as defined for tax purposes) are low, or to those benefiting from a discriminatory taxation. In any case, it is difficult to quantify this concession, especially considering the others presently being awarded, such as accelerated depreciation and the inventory tax relief. In this context it should be noted that the committee set up to study tax problems under inflationary conditions has recently submitted its recommendations to the government. These deal *inter alia* with the distortions arising from the treatment of linked loans under the current tax setup.

Along with the revision of development loans terms, changes were introduced in the terms of mortgage loans to households. In July 1979 the size of the loans was increased,[22] with the extra sum being given on indexed terms and the original amount still carrying fixed nominal interest ranging from 10 to 40 percent, depending on the regional location, size of the dwelling, economic situation of the home buyer, etc.[23] Indexed loans bear interest ranging between zero and 5 percent and subject to indexation. These loans are given for long periods (up to 20 years as

[21] From an examination of the repayment terms, and making a reasonable assumption as to the marginal tax rate, it would seem, at least on the surface, that under certain conditions the capitalized value of this concession might exceed the value of the loan.

[22] For a discussion of the volume of financing relative to the price of housing units see Chapter VIII, "Investment and Construction".

[23] In development areas the lion's share of the loans are given on an unlinked basis, while elsewhere they are subject to linkage.

compared with a maximum of 12 years previously), and so the initial repayment burden is light (as in the case of development loans). The borrower may choose to utilize only the indexed loan, without prejudicing his rights to receive a nonindexed loan. The total amount to be repaid on the indexed loan is updated every six months, but in the first year only 70 percent of the accrued indexation differentials must be paid (the balance is paid later on). On the other hand, the supplementary financing that used to be granted to eligible groups (as defined by the Ministry of Housing) from the mortgage banks' own resources, at interest ranging between 28 and 34 percent, was abolished (this financing had carried linkage insurance). In contrast to the producing sectors, which often enjoy a negative effective interest rate under the present taxation system, households bear the full price of indexed loans.

Some nondirected housing credit is given at a high nominal interest rate; the rest is granted on indexation terms, with an additional indexed interest charge of 7.5 percentage points. The interest rate on nonindexed mortgage credit for private housing was close to 50 percent at the beginning of 1979, and was scaled up during the year (with some lag) for the rise of prices. As the year wore on, mortgage banks tended to give loans at a floating rate that was revised every three to six months, at the bank's discretion, in line with changes in short-term bank interest rates. Toward the end of the year the share of indexed loans in total nondirected housing credit rose; this was partly due to the fact that the resources mobilized by the mortgage banks were themselves now largely value-linked.[24]

In the past the local authorities were among the recipients of indexed long-term credit. In 1978 their resort to such credit was prohibited, and to enable them to finance their investments they were granted credit at a nominal interest of 21-24 percent. This was provided through financial institutions, mostly under linkage insurance arrangements or out of budgetary deposits. Together with the linkage of directed nonhousing credit, that supplied to the local authorities was also linked, but only at 70 percent of the inflation rate. In this way the Local Authorities Union is able to exercise some control over the authorities' investment activity.

Some medium- and long-term credit is given, as stated, without government direction. However, the interest on such financing is determined not by market forces but by government intervention. On the one hand the government has set an interest rate ceiling of 7.5 percent on long-term linked credit, and on the other hand it accepts long-term linked deposits at a riskless average 6 percent rate. This in effect has set the interest rate on nondirected long-term credit, and the overwhelming share of such linked financing is in fact given at this rate.

[24] Since the Central Bureau of Statistics did not publish the average interest rates on housing loans this year, no precise, reliable data on this are available. However, it is clear that such interest rose steadily, and will continue to move up owing to the increasing utilization of indexed loans.

II. COMPONENTS OF THE CAPITAL MARKET

1. SOCIAL INSURANCE FUNDS

In 1979 household accumulation in social insurance funds was up 14 percent in real terms, compared with an increase of 20 percent in 1978 and 27 percent in 1977 (see Table XVII-11). The decline in the growth rate would almost certainly have been steeper had it not been for the institutional changes introduced in the pension and severance pay funds, whose accumulation is mainly a function of the increase in real wages (see below). In contrast, the bank-administered provident funds recorded an 11 percent smaller real accumulation in 1979, reversing the strong uptrend of the past few years. Most of the decline occurred in the second half of the year, and was consistent with the general decrease in voluntary (i.e. non-contributory) savings. The switch between pension and provident funds was more pronounced this year, as part of the membership shifted from basic to comprehensive pension plans, which offer additional rights. It is also possible that savers reduced their contributions to provident funds because of their extra rights in the comprehensive pension plans, which they joined under collective labor agreements.

The relative return on savings in social insurance funds increased in 1979, as many of the members moved to higher income brackets during the year. But it is hard to estimate the contribution of this factor to total voluntary savings in social insurance funds.[25]

The accumulation in bank-administered provident funds dipped 11 percent in real terms. The real rise in withdrawals was related to the increased liquidity of this savings channel, with the growing seniority of the members.[26] The expansion of the pension funds stemmed primarily from the 15 percent real rise in wages and salaries. In addition, part of the membership, as stated, shifted from basic to comprehensive pension plans under the existing wage agreements in the producing sectors. This increased employers' contributions by an amount equal to 6 percent of wages, besides adding a new component to the base for computing pensions. There was no real change during the year in withdrawals from pension funds; thus the net accumulation shot up at an unprecedented real 97 percent rate.

Under the pension agreements in the producing sectors employers have undertaken to adjust the value of the accumulated reserve in severance pay funds in line with their future pension liabilities, and as a result their contributions soared at an appreciable 42 percent real rate. The changes in the wage agreements also in-

[25] The ceiling for determining the maximum social insurance deposit eligible for tax benefits went up at a 14 percent real average annual rate in the past two years. It is not clear how effective this ceiling really is.

[26] Upon the termination of the savings period most of the deposits become a linked asset which can be realized at short notice. But the inability to redeposit the savings tends to discourage withdrawals. Hence this asset cannot be considered a liquid linked deposit in the full meaning of the term.

Table XVII-11

FLOW OF SAVINGS IN SOCIAL INSURANCE FUNDS,[a] 1977-79
(IL million)

	1977	1978	1979	Percent annual change 1977	1978	1979
Deposits						
Pension schemes	2,228	3,476	7,784	43	56	124
Provident schemes of the financial sector	2,903	5,262	9,121	51	81	73
Provident schemes of the Histadrut and companies	877	1,100	2,301	78	25	109
Severance pay and others	1,000	2,593	5,573	69	159	115
Total	**7,008**	**12,431**	**24,779**	**53**	**77**	**99**
Rate of real change in deposits[b]				13	18	12
Payments to members						
Pension schemes	1,509	2,654	4,899	49	76	85
Provident schemes of the financial sector	710	1,226	2,688	28	73	119
Provident schemes of the Histadrut and companies	349	399	548	37	14	37
Severance pay and other funds	588	1,213	2,534	17	106	109
Total	**3,156**	**5,492**	**10,669**	**36**	**74**	**94**
Rate of real change in payments[c]				1	16	9
Net accumulation						
Pension schemes	719	822	2,885	32	14	251
Provident schemes of the financial sector	2,193	4,036	6,433	60	84	59
Provident schemes of the Histadrut and companies	527	701	1,753	120	33	150
Severance pay and other funds	413	1,380	3,039	354	234	120
Total	**3,852**	**6,939**	**14,110**	**72**	**80**	**103**
Rate of real change in net accumulation[c]				32	19	16
Total wage payments in the economy	52,330	83,260	171,710	52	59	106
Total wage payments in the economy, less public and community services	33,880	54,120	110,090	46	60	103

[a] The classification of the social insurance funds has been changed this year from the institutional division used previously to a functional division of the main types of schemes.
[b] Deflated by the annual average change in the consumer price index.
[c] Deflated annually by the consumer price index; because of the reclassification of funds the rest of the data could not be deflated in the same way.
Source: For 1977-78 based on Central Bureau of Statistics data; for 1979—Bank of Israel.

Table XVII-12

SOURCES AND USES OF SOCIAL INSURANCE FUNDS, 1977-79
(IL million)

Sources	1977[a]	1978[a]	1979	Uses	1977[a]	1978[a]	1979
Net savings deposits[b]	3,850	6,940	14,110	Net transfers[c]	3,740	6,160	11,840
				Medium- and long-term credit	690	1,070	1,690
				Net short-term credit (up to two years)	120	150	400
				Net change in other short-term uses[d]	-140	-100	310
				Surplus of expenditure over income and net purchase of real assets	160	560	990
Repayment of medium- and long-term loans	720	900	1,120				
Total sources	**4,570**	**7,840**	**15,230**	Total uses	**4,570**	**7,840**	**15,230**

[a] Revised data.
[b] Net of payments to members; contributions to severance pay funds are treated as household savings.

Source: 1977 and 1978—based on Central Bureau of Statistics data; 1979—Bank of Israel.

[c] Net purchase of securities from original issues and in the secondary market.
[d] Includes the increase in net outstanding short-term assets and adjustment items.

Table XVII-13

COMBINED BALANCE SHEET OF SOCIAL INSURANCE FUNDS, 1977-79[a]
(IL million)

				Percentage distribution		
	1977	1978	1979	1977	1978	1979
Assets						
Securities	60,750	103,060	235,890	94.5	94.8	96.0
Loan to members[b]	1,270	1,770	2,840	2.0	1.6	1.2
Deposits and loans to others	970	1,550	2,750	1.5	1.4	1.1
Fixed assets	290	780	890	0.5	0.7	0.3
Employers' debt	330	430	980	0.5	0.4	0.4
Accrued interest and linkage increments receivable and other current assets	650	1,100	2,420	1.0	1.1	1.0
Total assets	**64,260**	**108,690**	**245,770**	**100.0**	**100.0**	**100.0**
Liabilities						
Pension reserve	27,700	44,860	75,020	43.1	41.3	30.5
Provident reserve (and advanced study schemes)	26,990	49,210	127,440	42.0	45.3	51.9
Severance pay, social benefit, and other reserves	6,720	11,160	24,690	10.5	10.3	10.0
General and other reserves	130	260	830	0.2	0.2	0.3
Auxiliary reserve and undistributed profits	2,370	2,640	13,900	3.7	2.4	5.7
Current liabilities	350	560	3,890	0.5	0.5	1.6
Total liabilities	**64,260**	**108,690**	**245,770**	**100.0**	**100.0**	**100.0**

[a] Linkage differentials are included in the relevant balance sheet items.
[b] Directly and through banks.
Source: 1977-78—Central Bureau of Statistics; 1979—Bank of Israel.

fluenced the accumulation in advanced study schemes: employers' contributions were raised to 7.5 percent, as compared with only 2.5 percent for employees. Additional groups of employees become eligible for this scheme, and the accumulation can be expected to expand further.

In conformity with Treasury regulations, social insurance funds invested the bulk of their resources in securities. This amounted to 84 percent of their accumulation this year, compared with 89 percent in 1978 and 98 percent in 1977 (see Table XVII-12). The funds are required to hold 92 percent of their accumulation in securities, but since they started the year with a surplus investment, they were able to divert less of their funds to the purchase of securities during the year and still meet the minimum requirements.

Table XVII-14

INCOME, OUTGO, AND ACCUMULATION OF LIFE INSURANCE COMPANIES IN ISRAEL,[a] 1977-79

(IL million)

	1977[b]	1978[b]	1979
1. Income			
Premiums	1,360	2,236	4,052
Interest	348	581	980
Total	**1,708**	**2,817**	**5,032**
2. Outgo			
Payments to policyholders	495	769	1,173
Agents' commissions	195	365	548
Other current expenses	198	365	693
Gross profit[c]	157	260	401
Total	**1,045**	**1,759**	**2,015**
3. Surplus of income over outgo	663	1,058	2,217
4. Income from investment of life insurance funds	1,383	3,032	7,189
5. Accumulation (3+4)	**2,046**	**4,090**	**9,406**

[a] Israeli and foreign insurance companies in Israel and Lloyd's agents; before deducting reinsurance abroad and net reinsurance in Israel.
[b] Revised data.
[c] Including profits of reinsurers abroad.
Source: Bank of Israel calculations based on a preliminary survey of the Central Bureau of Statistics for 1979, and on CBS, *Insurance in Israel*, for previous years.

Table XVII-15

GENERAL INSURANCE PREMIUM RECEIPTS,[a] 1977-79

	1977	1978[b]	1979
		IL million	
Total general premium receipts[c]	3,652	5,967	11,448
Motor vehicle insurance	1,467	2,481	3,956
Other insurance	2,185	3,486	7,492
		Percent annual increase	
Total general premium receipts	49.9	63.4	91.9
Motor vehicle insurance	41.9	69.1	59.5
Other insurance	55.7	59.5	114.9

[a] Of Israeli and foreign insurers and Lloyd's agents. Includes registration fees, including marine insurance and less reinsurance in Israel.
[b] Revised data.
[c] Includes registration and policy fees, collection fees, and other payments collected from policyholders.
Source: Bank of Israel calculations based on Central Bureau of Statistics surveys.

In contrast to last year, purchases of tradable securities from new issues or in the secondary market fell off in 1979. Nevertheless, the funds' secondary market transactions increased greatly.

2. INSURANCE COMPANIES

Total life insurance premium receipts reached IL4,052 million in 1979, as opposed to IL2,236 million the year before (see Table XVII-14). In contrast to previous years, no real increase was recorded in these receipts; the net accumulation in this savings channel came primarily from a real 15 percent decline in claims payments and a real decrease in commission fees. The slacker growth of premiums formed part of the general financial savings picture this year. The flagging of the growth rate was also due to the lag in adjusting premiums for many indexed life insurance policyholders.[27]

General insurance premium receipts went up 92 percent this year, compared with 63 percent in 1978 (see Table XVII-15). In 1978 motor vehicle insurance accounted for most of the increment, but this year such premiums advanced only 60 percent, while premium receipts from other classes of insurance jumped 115 percent.

The variability in motor vehicle insurance premiums is explained by changes in vehicle prices, which averaged 44 percent higher this year, after a much greater 103 percent rise the year before. Although there were 6 percent more vehicles in 1979, as compared with a 5 percent increase in 1978, the difference was not enough tooffset the effect of the real decline in vehicle prices on total premium receipts.

Most general insurance premiums are actually transfers payments, but a small percentage is accumulated and constitutes an addition to domestic savings. This is reflected in the general insurance reserve and to some extent in the pending and approved claims item (see Table XVII-16). The accumulation is used to purchase bonds and to supply credit in the free market.

[27] For policies written up to the beginning of 1975 the premiums are adjusted only twice a year; for more recent policies the insurance and premiums are adjusted every month.

Table XVII-16

ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES, 1977-79

	IL million			Percent		
	1977	1978[a]	1979	1977	1978[a]	1979
Assets						
Government or government-guaranteed bonds	7,075	12,086	23,283	58.8	60.4	63.0
Other securities	194	299	466	1.6	1.5	1.2
Loans on policies	136	193	394	1.1	1.0	1.1
Other loans	1,216	1,490	1,953	20.1	7.4	5.3
Time deposits	178	328	772	1.5	1.6	2.1
Real estate and investment in subsidiaries	419	1,012	1,354	3.5	5.1	3.7
Outstanding premiums	919	1,652	3,377	7.6	8.3	9.1
Sundry debtors	941	1,711	3,254	7.8	8.5	8.8
Cash and demand deposits	957	1,238	2,123	8.0	6.2	5.7
Total assets	**12,035**	**20,009**	**36,976**	**100.0**	**100.0**	**100.0**
Liabilities						
Paid-up share capital	360	644	871	3.0	3.2	2.4
General and other reserves	742	985	1,601	6.2	4.9	4.3
Life insurance reserve (less reinsurance)	5,494	9,410	18,292	45.7	47.0	49.5
General insurance reserve (less reinsurance)	1,141	2,049	3,771	9.4	10.2	10.2
Extraordinary risks reserve	359	532	955	3.0	2.7	2.6
Deposits of reinsurers	552	1,659	3,074	4.6	8.3	8.3
Pending and approved claims	2,193	3,710	6,958	18.2	18.6	18.8
Current liabilities	1,194	1,020	1,454	9.9	5.1	3.9
Total liabilities	**12,035**	**20,009**	**36,976**	**100.0**	**100.0**	**100.0**

[a] Revised data.
Source: Bank of Israel calculations based on Central Bureau of Statistics surveys.