

CHAPTER XVIII

THE INSTITUTIONAL STRUCTURE OF THE CAPITAL MARKET¹

1. MAIN DEVELOPMENTS

The resources available to the institutional structure of the capital market grew at a slower rate in 1976 than the year before – 25 percent as against 42 percent in 1975 – and the total resources amounted to IL 12.4 billion this year. However, the slowdown in the average annual rate of price level increases moderated the implied real decrease.

The most striking changes in the composition of resources available to the system were the decline in the weight of household savings and the increase in the weight of repayments of previous loans. The contribution of household savings to total resources declined from 57 percent in the past two years to only 51 percent this year, mainly because of the sharp drop in private savings. The decline in saving was accompanied by differential changes in its components: in real terms, the main decline was in the liquid savings components (direct holding of securities and participation certificates in mutual funds). A much smaller decline took place in the savings components of the long-term contractual type (savings programs, life insurance, and social insurance funds). The scope of this development derives not only from changes in the rate of savings and the character of different components, but also from changes that took place during the year in the relative rates of return; in the past three years uncertainty regarding the value of linked bonds held by the public due to possible changes in taxation and other terms of

¹ The institutional structure of the capital market is defined here as the system of financial intermediaries engaged primarily in the mobilization of medium- and long-term funds for investment in financial assets, such as loans, deposits, and securities. Included in this definition are banks providing development loans to various sectors, mortgage banks, investment companies of various financial concerns, household finance companies, such primary financial intermediaries as social insurance and pension funds, insurance companies, and mutual funds, as well as savings schemes (and the banks' own securities portfolios), and deposits for loan purposes administered by commercial banks separately from their monetary financial intermediation (the creation of money and granting of short-term credit). Excluded from this system are institutions financed by a limited number of proprietors and holding companies, the bulk of whose investment is in subsidiaries. This chapter therefore covers all institutional nonmonetary financial intermediation, apart from direct government operations in the capital market (such as the direct financing of local authorities, issuing bonds for households, collection of compulsory loans from households and business, etc.). These operations will be incorporated in the system in the future. This chapter does not include financial intermediation between the foreign sector and the units in the economy if executed by the commercial banking system. For a more detailed description of the statistical-analytic framework, see the Appendix to this Report or the Bank of Israel Annual Report 1974, pp. 447ff.

TABLE XVIII-1

GROSS MEDIUM- AND LONG-TERM CREDIT, 1974-1976

	Gross credit (IL million)			Price increase rates		Real change rate in credit volume	
	1974	1975	1976	1975	1976	1975	1976
To households	1,930	2,390	3,000				
1. Mortgage credit	1,450	1,860	2,110	30.0 ^a	12.7 ^a	-1.3	0.7
a. Directed	(1,220)	(1,600)	(1,640)	30.0 ^a	12.7 ^a	0.9	-9.1
b. For private housing	(230)	(260)	(470)	30.0 ^a	12.7 ^a	-13.0	60.4
2. Other credit	480	530	890	39.3 ^b	31.3 ^b	-20.7	27.9
To producing and service sectors	2,070	3,530	4,280				
1. Industry	940	1,650	2,380	40.3 ^c	40.3 ^c	25.1	15.7
2. Agriculture	490	630	850	37.7 ^c	25.1 ^c	-6.6	7.9
3. Construction	240	340	240				
4. Services	400	910	810	33.1 ^d	29.0 ^d	70.9	-31.0
To local authorities	720	870	1,050	33.0 ^e	30.0 ^e	-9.1	-7.2
Total	4,720	6,790	8,330				

a According to housing price index, annual average.

b According to Consumer Price Index, annual average.

c Derived investment data series, at fixed prices.

d Derived investment data series, of services and electricity, at fixed prices.

e According to derived public investment price index.

SOURCE: Table XVIII-2.

existing bonds has had an aggregate effect not only on the financial assets portfolio composition but also on total savings directed towards acquisition of financial assets.

The system's financial resources, which derive from repayments of loans received in the past, grew at a similar rate to that of the previous year, but in real terms there was an acceleration of 8 percent as compared with 2 percent last year.² This financing resource is not affected by current developments, but rather is a derivative of the extent and terms of credit in the past, though its real size is affected by the changes in the current rate of price increases. This example emphasizes the disadvantages in subsidizing investments in a manner that does not take into account changes in the rate of price increases during the period of loan repayment.

Within the system's financing operations there was a decline in the growth rate of credit granted to households, the economic sectors and local authorities: 23 percent as compared with 44 percent last year. Due to the slowdown in the average annual rate of price increases and a real reduction in investments in the economy, there was a rise in the rates of financing through the system. It should be noted that the upward trend in the interest rates on new loans continued by 3 percent during the year. The share of households, economic sectors and local authorities in total credit granted by the system remained stable, and it seems that this was due to the real development in investments, which was similar in these sectors.

Credit to households, which reached IL 3 billion this year and was granted mainly for acquisition of housing (but also for other purposes), grew at the same rate as last year, and increased in real terms as well (see Table XVIII-1). The rise was mainly the result of the growth in mortgage credit for private housing (about 60 percent in real terms), as well as in "other credit". The number of directed mortgage credit types rose, though total credit of this type declined in real terms³ by 9 percent.

Credit for financing investments in industry increased this year at a slower rate than last year, but in view of a stronger slowdown in the growth rate of investments, there was a considerable rise in the rate of financing: from 44 percent last year to 58 percent this year. In real terms there was a decline of 11 percent in industrial investments, but credit grew by 16 percent⁴ and the result, as mentioned previously, was a considerable rise in the rate of financing, with no change in the terms of eligibility for investment financing. This increase derives partly from specific decisions to raise the rates of financing for particular branches or financing frameworks, but for the most part we have no adequate explanation.

² Unless otherwise stated, the price rise is discounted by the Consumer Price Index.

³ Discounted by the housing price index, at an annual average.

⁴ Discounted by the index derived from investment data at fixed prices.

The credit picture in agriculture is similar to that of industry, though not as intensified. In real terms, investments declined by 3.2 percent this year, but financing grew by 7.9 percent; as a result, the rate of financing increased from 70 percent last year to 78 percent this year.

Credit to local authorities grew at a similar rate to last year, about 21 percent, though in real terms⁵ it continued to decline, due especially to the Ministry of Interior's administrative restraint of the increase in the government financing rate and the deferring of investment projects.

The credit granted by the system to the service and construction sectors was reduced this year; these sectors depend less on the system for financing their credit needs. The decline is partly related to the steep drop in the construction of hotels and in new building starts, but is also partly a reaction to the extraordinary increase in the volume of credit last year.⁶

It should be emphasized, that there has been a substantial drop in the government's absorption of resources from the institutional structure of the capital market this year, together with a sharp rise in the absorption of the banking system. Net credit to government declined from IL 1.7 billion last year to IL 0.9 billion this year, while its weight in total uses dropped from 17 percent to only 7 percent. In view of the rising rates of financing in most of those sectors receiving credit from the system, this sharp decline is contrary to the trend expressed by enlarging government absorption through taxation and the policy of restricting the entire aggregate demand.

The commercial banks (in other words, the short-term money market) absorbed about IL one billion this year from the long-term capital market system, whereas last year there was no such absorption at all.⁷ Two reasons for this increase in absorption of resources: the change in the composition of savings (in favor of bank savings programs), and the central role played by the commercial banks in the payment mechanism of the system, which allows them a certain influence on the directing of funds. This increase is connected both with the efforts made this year by the commercial banks to decrease liquidity deficits and with the high interest rates in the monetary market (see Chapter XVII).

⁵ Discounted by the Investment Index of the nonprofit institutions.

⁶ In contrast, there are signs that due to the accumulation of unsold flats, especially in development areas, there was an increase in short-term financing granted to construction companies by the system.

⁷ This development is partly related to an advanced purchase of securities by the financial institutions at the end of last year, financed by bank credit, but even after an appropriate "dispersal" of the phenomenon, one can observe an accelerated absorption of means from the capital market by the banking system.

I. OVERALL ANALYSIS

I. GOVERNMENT INFLUENCE ON THE SYSTEM

The degree to which the government determines the nature and volume of the institutions' operations far transcends the weight of the system's direct financial transactions with the government. In fact, the government is involved in the entire financial intermediation process. This applies to: (a) the mobilization of primary sources of funds (mostly household savings through provident and pension funds, insurance companies, savings schemes and mutual funds); (b) the intermediate stage of financial intermediation, i.e., the transfer of most resources mobilized to secondary financial intermediaries (in other words, the financial institutions), as well as deposits for loan grants within the banking system through the purchase of bonds and the placing of deposits for loan purposes by the primary financial intermediaries; (c) the final stage of channeling funds to the various sectors of the economy and to households for financing production and consumption.

In the first stage, the government is responsible for the lion's share of the economy's voluntary saving finding its way to the system of intermediaries, as it either directly or indirectly permits them to guarantee the public a long-term positive real return of up to 5 percent regardless of the inflation rate, in addition to granting income tax concessions on earnings from this source, and in some frameworks, even on the primary deposits. The upshot is that the government has in effect prevented the development of a substantial capital market alongside the system discussed here — one that could compete in raising funds from domestic sources. At the same time government intervention has undoubtedly had a positive effect on the level of saving in the economy, especially in periods of high inflation.

As to the second stage, by requiring the primary financial intermediaries to divert between 75 and 92 percent of their resources to the acquisition of bonds (considered a recognized investment for purposes of regulations), the government assures that most of the funds so raised go to the purchase of financial institution bonds as well as its own issues.

Regarding the third stage, every financial institution seeking to raise capital through the flotation of bonds (or other securities) has to obtain a special permit for this; this applies in particular to institutions desiring "approved investment" recognition for a proposed bond issue (for the purposes of the regulation governing the placing of primary financial intermediaries' resources). The Treasury can make the receipt of the permit conditional on the institution's agreeing to the allocation of the issue proceeds (either wholly or in part) in accordance with its guidelines. The Treasury actually makes extensive use of this power, and it directly and indirectly controls the overwhelming portion

TABLE
SOURCES AND USES OF MEDIUM- AND LONG-TERM
 (IL)

Sources	1974	1975	1976
Household savings, net of withdrawals	4,530	6,250	7,060
Business deposits and sale of securities ^a (net)	440	310	300
Net receipts from household and business security transactions	-590	-650	-780
Total	4,380	5,910	6,580
Loan repayments from:			
Households	740	1,150	1,460
Business	1,260	1,760	2,740
Local authorities	490	630	840
Subtotal	2,490	3,540	5,040
National Institutions (net)	130	190	260
Rest of the world (net) ^b	-50	280	410
Unknown	20	0	100
Subtotal	100	470	770
Total sources	6,970	9,920	12,390

NOTE: Receipts and payments on account of medium- and long-term debt repayment, savings withdrawals, and redemption of securities include not only the principal but also interest and linkage increments paid. In the flow-of-funds system these components were previously defined as real (i.e. nonfinancial) transactions and included in the surplus of income over expenditure. In the present system the "surplus of expenditure over income" includes, in addition to payroll, services charges, purchases of assets, etc., only interest received and paid on short-term credit transactions. It should not be concluded from this that the intermediaries wind up the year with an operating loss; most of the interest and linkage differential items in their financial statements are included under other items in this table or are totally excluded from the system.

XVIII-2

FUNDS – CAPITAL MARKET INTERMEDIARIES, 1974–1976
 million)

Uses	1974	1975	1976
Gross medium- and long-term credit to:			
Households	1,930	2,390	3,000
Agriculture	490	630	850
Industry	940	1,650	2,380
Construction	240	340	240
Services (incl. electricity)	400	910	810
Local authorities	720	870	1,050
Total	4,720	6,790	8,330
Net transfers to:			
Government	1,210	1,660	910
Banking institutions	350	(-10)	980
Total	1,560	1,650	1,890
Short-term uses, net ^c	180	580	610
Surplus of expenditure over income	500	920	1,180
Dividends	260	380	710
Other payments, net ^d	(-250)	(-400)	(-330)
Total uses	6,970	9,920	12,390

^a The net proceeds from security transactions with households and businesses (see the detailed explanation in Section 2 of the 1974 Annual Report, pp.479 ff.).

^b Includes short-term transactions of the intermediaries with the foreign sector.

^c The increase in outstanding short-term assets, including cash and demand deposits, less the increase in outstanding short-term liabilities (does not include short-term items in connection with allocations to reserves and other bookkeeping entries or transactions with the foreign sector).

^d Taxes, general insurance premium and claims payments, and receipts and payments in connection with reinsurance.

SOURCE: Estimates of the Research Department, Bank of Israel.

of such proceeds, in conformity with national development policy. It makes available unlinked loans bearing a relatively low nominal interest for high-priority activities and needs. The government essentially serves as an intermediary between the funds raised by bond issues, either governmental or of the financial institutions (at terms identical to government terms), and those funds that partially flow back to the financial institutions for cheap loan grants under government direction. During intermediation, these funds are deposited with the government on terms which take into account the terms on which the credit is to be granted, and the profit margin guaranteed to the institutions. However, only a relatively small share of the preferred activities and requirements of the public sector is financed in this way: the greater part of this low-cost financing is granted by the financial institutions from their own bond issue proceeds in accordance with government guidelines. The Treasury compensates the financial institutions for the difference between the price of the capital so raised and its linkage terms on the one hand, and the terms of the credit granted on the other.

In actual fact, the major part of the credit originating in bond issue proceeds is directed by the government, and is granted on unlinked, low interest terms, with linkage differentials covered by the Treasury. The relatively small portion of the bond issue revenues which is defined as "free" of government control for the most part constitutes the institutions' contribution to the subsidized credit funds from their freely loanable resources, and this because of their desire to assure Treasury cover of the linkage differentials.

In order to see the overall picture of government influence on the system's activity, one other facet of the government intervention should be noted. The raising of capital abroad requires a special permit from the Treasury's Foreign Exchange Department; in view of the limited possibilities of the financial institutions to grant loans linked to foreign currency (especially since the introduction of the creeping devaluation in June 1975) they generally tend to grant such loans too in conformity with public sector guidelines in order to be entitled to linkage differential coverage. In conclusion it can be said that government influence on the nature and level of activity of the system is most extensive.

However, the system still maintains a relatively narrow area, of independent medium- and long-term control-free credit grants, whose financial resources are mainly free means of the provident pension funds, insurance companies and approved savings programs (within the framework of voluntary acquisition of securities), as well as means supplied by business concerns and other sources. The volume of these resources depends largely on monetary developments and the economy's liquidity situation.⁸

⁸ It should be mentioned that the financial institutions of Hevrat Ovdim (the framework for industrial and other economic activity of the General Trade Union Organization) obtained a general permit to use an agreed portion of the resources that they mobilize to finance the investment program of Hevrat Ovdim.

2. SOURCES OF FUNDS

A. GENERAL⁹

The intermediaries' principal source of funds is the household sector, which mainly takes the shape of saving through social insurance funds, insurance companies, approved savings schemes, and mutual funds. In the years before 1974, households supplied a growing volume of funds through direct purchases of securities issued in the primary market and sold by the institutions in the secondary market. Since 1974, this component has become negative — that is to say, there was a net public redemption, or redemption and sale of securities to the system through the secondary market. While the scope of the household contribution to the system's resources, through social insurance fund accounts and other primary intermediaries, can be identified directly, their contribution through securities purchases cannot be isolated. Nevertheless, it can be estimated by the financial contribution from the issue and redemption of securities, and the purchase and sale of securities of the system to households. This contribution also includes a small component of the net financial result of business in the secondary market (see Table XVIII-2).

Businesses, besides borrowing from the intermediaries, supply them with funds (albeit on a relatively modest scale) in the form of earmarked loan deposits (primarily for financing households and local authorities), as well as through the purchase of financial institution bonds in the primary market. Also included in this source are the monies transferred by the State Lottery, chiefly for onlending to local authorities. Other quite modest contributing sectors are the National Institutions and the foreign sector.

Another, more significant, source is current payments (principal, interest and linkage differentials) on account of the borrowers' (households, business, and local authorities) obligations.

Not all the receipts from the sources listed above are lent to the producing and consuming public. Part is absorbed by the government and the banking institutions, whose relations with the intermediaries are quite complex. The government pumps out money through its fiscal policies for financing its operations, including repumping of funds to the institutions. The banking institutions, which mobilize funds for their affiliated financial concerns, channel to them a sizeable share of the intermediaries resources, part of which flows back to the latter and is redistributed among secondary financial intermediaries. The affiliated financial concerns transfer part of their mobilized resources (mainly bond issue proceeds, but also savings, loans and deposits from both domestic and foreign sources, etc.) to the parent banks. Some of these funds are deposited with the Treasury and/or lent out in the name of the financial concerns. Another part consists of deposits to an unspecified destination. On the other hand, the parent banks place various deposits

⁹ See Table XVIII-1

with these affiliates — representing both their share in the financing of the concerns' operations and repayments of deposits that have matured. Difference between the monthly fund-flows from the system of intermediaries to the banking sector and the return flows to the intermediaries, as well as that portion of mobilized savings in savings programs which do not require recognized investment and is not invested in securities, can affect the current liquidity position of the banks and thus their shortfalls in liquid asset cover. Therefore, the institutional system of the capital market serves as a kind of regulator capable of transmitting liquidity deficits (or injections) between the government and the banking system, and vice versa.

b. Volume and Composition of the Resources

The system's nominal resource volume did not maintain its growth rate in 1976, contrary to the previous year, and consequently, real volume declined. These resources increased this year at a rate of 25 percent and amounted to IL 12.4 billion, as compared with a growth rate of 42 percent in each of the two previous years. Although the annual average price level rose this year at a lower rate than last, there was a real decline of 5 percent in the volume of the system's resources, as against a real rise of 2 percent in each of the two previous years. The ratio between the volume of medium- and long-term credit granted and the total volume of financial transactions continued to shrink this year, reaching 23 percent. This enormous gap between the volume of credit and the volume of transactions is primarily related to the multistage financial intermediation process, which in no way contributes to a more efficient capital market, and surely does not further the public sector's control over the volume of the resources it subsidizes¹⁰.

The most outstanding developments in the composition of resources are the accelerated decline in the weight of household savings, which is the major component of the resources, and the increase of the second component, namely the repayment of loans granted in previous years. The weight of household savings in total resources which reached 57 and 56 percent in 1974 and 1975 respectively, only reached 51 percent this year. At the same time, the weight of repayment of previous loans increased from 36 percent in the previous two years to 41 percent this year.

¹⁰ Because of the specialization of the primary and secondary intermediaries, it is reasonable that there should be a certain gap between the volume of credit and that of transactions, but not to such an extent as in the Israeli economy, and there is certainly no reason to desire that this gap be widened in relative terms.

This development derives from a considerable decline in the real volume of savings directed by households (and businesses) to the capital market system. To a great extent it expresses a sharp decline in the domestic rate of saving. Total household savings (including business deposits and the acquisition of securities, less redemption payments), which were directed to the capital market system, increased by 11 percent this year, as against 35 percent in 1975, and 52 percent in 1974. In real terms, the resources of households put at the disposal of the system declined by 15 percent, as against a decline of 3 percent in 1975 and a rise of 9 percent in 1974.

The adjustment of demand to supply in medium- and long-term credit resources is made to a limited extent only by changes in the interest rates (which affect only the demand intervention) and much more by government involvement. This fact is expressed partly by the allocation of credit and the net volume of resources, drawn by the government from the system for financing its credit requirements. In the years 1974 and 1975 the government drew about 17 percent of the total resources of the system, while this year the rate dropped to only 7 percent. This development is partially the result of a considerable decline in the volume of household savings and partially of the rise in financing rates for most types of investment financed by the system. This does not correlate with the policy applied this year to restrain aggregate demand. However, if the decline in the rates of saving is partially related to the considerable increase in tax collection, it cannot be considered a decrease in the total resources put at the government's disposal by households; it may also indicate a more stable structure of budget financing. It must be emphasized that the commercial banking system, as well as the government, uses the capital market institutional system as a supplier of financing resources for its activity, and it absorbed about IL one billion this year. In 1975, the banking system did not absorb financing resources from the system, but this was mainly due to a massive advanced acquisition of bonds by institutional investors towards the end of the year, in hope of realizing capital gains (acquisitions financed by bank credit).

In order to receive a true picture, this year's absorption must be "dispersed" over two years, though even this way, resource absorption from the system accelerated this year. This development must be regarded in view of banking system efforts to decrease deficits in liquid assets, and especially in view of the high cost of financial resources to this system. The background to the absorption of means by the banking system is the developments in the money market, the aggregate demand policy and government absorption. The total absorption of the government and the banking institutions from the capital market reached 15 percent this year against 17 percent last year.

This year the weight of resources put at the disposal of the system by the foreign sector declined to 3.3 percent of its total resources. Most of these resources are not free, being directed by the authorities, who generally take the responsibility for exchange rate insurance. This year there are signs of growing need for foreign credit directly through commercial banks, and it has therefore not been included in the system's data.

c. Funds from Households and Business

The downward trend in the growth rate of the financial resources supplied by households and businesses intensified this year; in spite of the slowdown in the rate of annual average price increases, their real volume declined considerably. This trend correlates with this year's sharp decline in the gross private rate, from a level of 34 percent of the total resources to a level of only 27 percent this year.

TABLE XVIII-3

FUNDS SUPPLIED TO THE SYSTEM BY HOUSEHOLDS, BY SOURCE, 1974-1976
(IL million)

	1974	1975	1976	Percent annual change		
				1974	1975	1976
Social insurance fund savings ^a	1,510	1,740	2,160	70	15	25
Approved savings schemes ^{a,c}	1,700	2,190	2,460	214	29	12
Mutual funds ^a	1,000	1,870	1,820	717	87	-3
Life insurance	320	450	620	78	41	38
Subtotal	4,530	6,250	7,060	145	38	13
Net receipts from security transactions - households and business ^b	-600	-650	-780	-	-	-
Total	3,930	5,600	6,280	45	42	12

^a Deposits (or premiums) less withdrawals of principal, interest, and linkage increments.

^b Purchase of original-issue securities by the system of intermediaries, less redemptions and net sales in the secondary market.

^c Including bank savings programs and savings programs for housing and education.

SOURCE : Estimates of the Research Department, Bank of Israel.

The sharp decline in the saving rate was accompanied by a considerable change in the development of various saving components. This was partially due to changes in the

desired structure of the financial assets portfolio, and partially because of a sensitivity of the accumulation in the different saving frameworks to changes in the volume of savings.

Direct holding of securities by households continued to decline this year, and this was expressed in the net redemption and/or sale of IL 780 million, as against IL 650 and IL 590 million in the years 1975 and 1974 respectively.¹¹ A number of developments acting in the same direction were responsible for this result: the decline of the domestic saving rate; the public's uncertainty regarding taxation on linkage differentials of its bonds; the tax reform in mid-1975 which lowered the profitability of acquiring linked securities by business; the reduction of bond index-linkage rates to 90 percent (in December 1975), and then to 80 percent (in December 1976); and the various attempts to act against "black capital" invested in securities. These developments affected not only the allocation of current savings but also the structural change of the existing financial assets portfolio, which resulted in a net sale out of the public securities portfolio. It should be stressed that net redemption and/or sale to the system institutions has been taking place since 1974, when rumors spread about expected worsened terms on bonds linked to the price index held by the public (by means of a tax on linkage profits). The atmosphere of uncertainty in the last years has had an intensifying aggregate effect on the value of linked bonds. If this uncertainty continues, it may affect the propensity to save, and especially the investment in financial assets.

This year, there has been a slowdown in the growth of demand for certificates of participation in mutual funds. The growth rate of saving in this framework declined by 3 percent, reaching IL 1.8 billion. The main factor affecting the direct holding of securities also acted on indirect holding through participation certificates in mutual funds. A balancing factor was the policy of the bank securities counselors, who advised the public away from the direct holding of securities to the acquisition of participation certificates in mutual funds. Furthermore, it is possible that the dynamic developments and changes in trend which characterized the entire securities market (stocks, index-linked bonds, and the Natad dollar) entailed the necessity for professional advice and frequent updating, and therefore increased the demand for mutual fund services.

The institutional savings schemes with long-term commitments showed a slower decline, and there was even a certain acceleration of allocations in social insurance funds. Generally, one can say that this development occurred owing to the long-term character of the commitment and the relative improvement in return, as well as the feeling of security provided by these funds in comparison to other forms of savings (although the

¹¹ These data do not include the net acquisition or redemption of government bonds held by the public, but various indicators show that a net sale took place in this portfolio as well.

decline in the liquidity of the financial assets of most of these saving frameworks continued).

Within the framework of the bank savings programs, the growth rate of net allocations declined to 12 percent this year as against 29 percent last year, and 214 percent in 1974. Savings programs prospered in 1974, following the implementation of programs giving an additional bonus to the "diligent saver" (which increased both the expectation of return and the incentive for nonbreach of the program before the end of the period.¹² These programs were further encouraged by means of an incentive to the banks, when that part of the savings which they can use freely was raised from 15 to 25 percent¹³ of the total. Naturally the growth rate cannot continue to accelerate for long, though this framework is still benefiting from a considerable preference in the banks' recommendations, especially in 1976 when there was strong pressure on the banks to reduce liquidity deficits. Even under the restrictions on free credit, banks that raised savings in this framework had priority.

The main changes that took place in the savings programs in 1976 were the implementation of the "18,000 Programs" in April, which increased the maximum deposit permitted from IL 10,000 to IL 18,000 while extending the required saving period from 5 to 6 years, and in December, the reduction of the interest rate to the saver by one percent. It should be emphasized that the savings programs maintained full linkage to the index, whereas linkage on bonds issued to the public decreased from the end of 1975 to the end of 1976 from 100 percent to 80 percent, improving the relative return of the former. If we add to this the strong incentive not to "breach" the savings programs, and the steering of the public by the banks' advisory services to these programs, the growth in their volume can be understood, in spite of developments in the direct holding of securities and mutual funds.

Social insurance funds were the only type of saving that showed accelerated growth this year, at a rate of 25 percent as against 15 percent last year, totaling IL 2,160 million, even though the decline in real terms continued, its rate reaching 5 percent this year.

This acceleration corresponds entirely to developments in the provident funds of the banks, which are open to the public, as against company funds, which include only the employees of the promoting enterprise. Allocation rates to these funds are fixed and stipulated in the work agreements of the companies. This accelerated saving was the result of developments in the entire financial assets market, which greatly affected the composition of demand for financial assets, as well as the accumulation of institutional

¹² Prior to this the breach of programs was a widespread phenomenon: less than half of the savers completed the planned saving period.

¹³ In April 1976 this element was reduced, regarding the accumulation in new programs, to only 17 percent, while at the same time the rate of the banks' participation in the bonus was decreased.

changes, which contributed to the improvement of the relative standing of the provident funds (from the point of the saver's return), and a decline in the propensity to draw savings at the earliest possible date. It should be noted that the increase in the provident funds' annual accumulation from 10 percent last year to 36 percent this year, derives both from the accelerated rate of deposits (from 25 percent to 44 percent this year) and the slowdown in the growth rate of withdrawals (from 97 percent last year to 62 percent this year).¹⁴

In spite of the similarity in the characteristics of the various savings programs and provident funds, developments within these frameworks were different this year, for no clear reason.

The financial relations of the banking sector to the capital market institutional system discussed in this chapter are no less complex than those of the latter with the government. The banking institutions fulfill the function of coordinator of funds for financial concerns¹⁵ with which they are affiliated. In this way the large banks channel to them a substantial part of the system's resources and redistribute them among the system's secondary financial intermediaries.¹⁶ In this way the banks channeled IL 4.3 billion to them this year (see columns 2 and 5 in Table XVIII-4) and then reallocated IL 3.3 billion (see columns 1 and 4 in Table XVIII-4), leaving IL one billion for the use of the banking system (even though part of this amount must be attributed to the previous year, see above).

d. Loan Repayments

Current payments of borrowers' obligations rose by 42 percent this year, the same as last year, and amounted to IL 5 billion; in real terms the increase was 8 percent, as compared with only 2 percent last year. The nominal volume of this financing resource was fixed by past activity (volume of loans, length of loan periods, and terms of interest). Current developments in the capital market system do not affect it.

In the regular development of the capital market system and the economic growth, one can expect an increase in the weight of repayments, as against the weight of current household savings, in the system's total resources. The growth rate of repayments depends mainly on the growth rate of credit in past years, interest rates and the length of the loan period. In recent years, there has been a downward trend in the growth rate of credit as well as an increase in the interest rate and a decline in the average period of a

14 For a more detailed explanation, see Part II, the section on social insurance funds.

15 A concern generally includes social insurance funds, insurance companies, savings programs, mutual funds, investment companies, development banks and mortgage banks.

16 Those financial institutions which specialize in granting credit to households and other economic sectors, as opposed to the primary intermediaries, which specialize in absorbing household savings.

TABLE XVIII.4

**FLOW OF FUNDS BETWEEN THE SYSTEM AND THE GOVERNMENT AND BANKING
INSTITUTIONS, 1974-1976**
(IL million)

Sector	Year	Receipts o/a	Payments o/a	Surplus of	Current	Current	Surplus of cur-	Total
		long-term assets ^a	long-term liabilities ^a	long-term re- ceipts over payments (1-2)	long-term receipts ^b	long-term payments ^b	rent receipts over pay- ments ^b (4-5)	
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
Govern- ment	1974	2,040*	470	1,570	1,080	3,860	- 2,870	-1,210
	1975	2,870	490	2,380	1,820	5,860	- 4,040	-1,660
	1976	4,230	690	3,540	2,630	7,080	-4,450	-910
Banking institutions	1974	530	320	210	850	1,410	-560	-530
	1975	1,060	480	580	1,490	2,060	-570	10
	1976	1,330	860	470	1,950	3,400	-1,450	-980

^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 and col.2 of redeposits.

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

SOURCE: Estimates of the Research Department, Bank of Israel.

number of credit classifications. The weight of the repayment component in resources could have been much higher, had the credit been granted at interest terms more similar to those paid on household savings (such as linkage to the price index or higher interest rates). This would have aided in reducing the government deficit, in restricting government need of the system's resources, and of course, it would also have had an effect on the scope of monetary injection.¹⁷

3. CREDIT TERMS AND DESTINATION

a. Credit Terms

Most of the medium- and long-term lending of the system consists of unlinked low-interest credit allocated according to the public sector's directives and at its expense. This applies especially to the funds supplied to households, agriculture, and industry (more than 90 percent of which was granted on concessionary terms). It also applies to part of the financing made available to the construction sector, and to a much smaller extent to local authorities.

Development credits extended in accordance with government guidelines to industry, agriculture, and tourism¹⁸ have been granted unlinked and at a quite low nominal rate of interest since the mid-1960's. Interest on loans made in 1976 ranged between 12 and 17 percent, depending on the firm's location and the economic destination of its output. Another part of the subsidized financing to these sectors was granted unlinked at 17 percent, on the instructions of authorized public bodies.

Directed mortgage credit (and some other credit to households) is also unlinked and bears interest of 10-19 percent (with an upward trend in the past two years). As regards part of the nondirected mortgage credit for private housing, which is subject to certain price and space limitations, the mortgage banks are likewise allowed to grant it unlinked (on the public sector's account) at interest ranging from 13 to 20 percent, and at the beginning of 1977 it was increased to between 16 and 27 percent. Most of the loans granted this year carried these terms.

Since the middle of 1974, interest on directed credit to industry, agriculture and households has been rising continuously, generally reaching 3 to 5 percent in 1976,

¹⁷ Because of the asymmetric interest arrangements between savings and credit, households can maintain a level of expected income flow from their public savings, and even increase it, without increasing their net savings by the same amount. Net saving is affected by the size of the amounts repaid by the system to households (which are linked), and by the size of amounts repaid by the households to the system (which are unlinked).

¹⁸ Hotel construction loans are classified here as credit to the service sector.

and in some areas interest was again raised at the beginning of 1977. These interest rates are in fact a significant resource for subsidizing investments, but the increase of interest rates on new loans and the slowdown this year in the annual average rate of price increases has reduced the scope of subsidies granted to these branches. It seems that in order to increase public control over subsidized investments in the economic sectors and housing, the same measures as those taken at the beginning of 1977 should be taken with regard to interest on credit to industry: a low basic interest rate (5 percent) plus half the differentials of linkage to the price index.¹⁹ Developments in mortgage credit were similar: in addition to the increase of interest rates, there was a propensity to shorten the loan period and apply a progressive repayment schedule in order to maintain a real, homogeneous repayment burden throughout the period.

b. Volume of Credit

The gross medium- and long-term credit volume extended by the system (to households, economic sectors and local authorities) increased in 1976 by 23 percent and amounted to IL 8,330 million, as compared with an increase of 44 percent in 1975 and 49 percent in 1974. In view of the sharp slowdown in the growth rate of investments and acquisition of flats, financing rates for most operations financed by the system increased considerably.

The decline in the growth rate of credit was concentrated in industry, construction and services; in the two latter sectors there was even an absolute decline in the gross credit volume. In contrast, the growth rate of credit to households and local authorities was similar to last year, and only the growth rates of the volume of credit extended to agriculture showed any acceleration this year.

The growth rate of credit to local authorities, which reached 21 percent this year (similar to last year), corresponded with the growth rate of investments (at current prices), contrary to last year, when the growth rate of investments was much higher (35 percent). One must remember, though, that the local authority sector depends to a great extent on direct public financing. It seems that its weight in investment financing increased recently, in parallel to the administrative restraint of the Ministry of Interior and the deferring of projects, both of which were characteristic this year. It should be emphasized that in this sector the link between the long- and medium-term credit volume and the volume of investments is not strong. This is because of changes in the government participation rate in financing, as well as the authorities' custom of borrowing for "rolling" previous debts and not merely for financing investments (when repayment

¹⁹ By maintaining a ceiling which becomes effective upon annual price increases of 14 to 24 percent, according to the area of investment.

derives from current income). One should note the fact that the authorities required credit from the commercial banking system as well, but these transactions are not included here.

The real decline in the scope of financing granted by the system to the local authorities is not the result of an abundance of alternative resources, or their inability to compete with the system's financing resources through interest rates, but is rather the result of tighter control by the Ministry of Interior.

Contrary to previous years' developments, this year the stability in the composition of financing granted by the system was notable: the share of households, economic sectors and local authorities in total credit remained stable. This is apparently connected with the great similarity this year in the real developments in the investment volume of various sectors, even though this is only a partial explanation.

c. Credit to Households

The slow growth rate of credit extended by the system to households continued in 1976, by 26 percent, as against 24 and 78 percent in 1975 and 1974 respectively. Total credit extended during this year amounted to IL 3 billion. In 1974 acceleration in housing credit to households was a result of the post-war recovery of cheap credit to released soldiers. Credit to the economic sectors accelerated only in 1975 due to the delayed recovery of their activities.

The major household credit element, mortgage credit, increased at a rate of 13 percent this year, as against 28 and 88 percent in 1975 and 1974 respectively; other credit increased at a much faster rate and reached 59 percent, but its volume is small. Other household credit mainly included credit for savings in social insurance funds and insurance companies (partly unlinked and partly indirectly linked), subsidized credit extended mainly to new immigrants, civil servants and university students, as well as credit extended by mortgage banks for renovation of buildings and transition from rental to acquisition. Among the elements with an accelerated growth rate, one must note the credit from loan deposits extended by the commercial banking system, and other credit from mortgage banks. In contrast, the growth rate of nonmortgage credit to new immigrants slowed (paralleling the slowdown in the rate of immigration), as did that of credit from social insurance funds (due to the continuing increase in the weight of complex investment in total uses).

In mortgage credit, the growth in volume for private housing stands out. The number of apartments acquired on the private market declined by 11 percent this year, and their price increased by 12 percent on the average, so that the total money value of sales remained stable. However, the slump in the housing market and the increase in the free resources of mortgage banks, due to the sharp decline in acquisition of public

housing, caused a growth in the supply of private housing credit (initiated by the contractors and the banks). As a result, total credit for private housing grew by 80 percent, and totaled IL 470 million; this is the decisive contribution to the growth in total mortgage credit (11 percent out of a 13 percent growth). Interest rates on credit for private housing acquisition this year ranged between 13 and 20 percent, according to the apartment price; the difference between this price and the cost of resources to the banks was borne by the government. At the beginning of 1977, the interest was raised and now stands at 16 to 27 percent. In this way, it was possible to finance private housing acquisitions even if their prices exceeded the ceiling, although the public sector did not subsidize this credit, and the customers were obliged to pay 33 percent interest, but the credit volume for financing such "excesses" was relatively small. Most of the credit for private dwelling was extended through housing companies that comply with the restrictions set by the public sector.

In other areas of housing acquisition there was a sharp decline this year, beyond that of private housing. We do not possess reliable data as to the number of flats sold within this system, and it is difficult to obtain a good indication, even from movements in the number of loans, since this year there was an increase in the number of complementing loan variations (for released soldiers towards the end of the registration period, in the framework of trade unions, and others). The total numbers of loans, except those for private housing and an estimated increase in complementing loans, declined by 9 percent this year, but this data must be regarded with reservations as to the number of flats sold, since on the average, more than one loan is granted for each flat acquired, and this ratio may change over the years.

Interest rates on mortgage credit within the different frameworks increased in 1976 and this trend continued at the beginning of 1977. The interest for tenants of the Saving for Housing Scheme ranged between 12 and 21 percent in 1976, and between 15 and 27 percent at the beginning of 1977. Interest on credit for relocated families and young couples varied greatly (between 6 and 19 percent), while interest on credit for new immigrants ranged between 11.75 and 13.5 percent.

It should be noted that in view of the slowdown in the sale of flats, especially in neighborhoods and settlements not highly in demand, the regular financing criteria were not maintained. Under this policy, certain neighborhoods and settlements were declared priority areas (often for a limited period only), and loans granted to tenants were raised. In the life insurance plans, net savings increased by 38 percent this year, as against 41 percent last year, and it amounted to IL 620 million. This is a real increase of 5 percent, as compared with only one percent last year. This development corresponds with public behavior regarding long-term savings programs. In addition to that, this framework does not only supply saving services, but also insurance services, which are sold as a "package deal" with a savings element. There is no reason to assume that there was a

decline in this area in 1976. There are signs that demand for life insurance schemes with a smaller saving element increased, which suggests that the main demand is for the insurance services and not the savings.

d. Government and Banking System Absorption

The weight of the net government absorption from the intermediaries is rather small, but, as previously mentioned, this by no means reflects the extent of government intervention in their operation (see above).

TABLE XVIII-5

**GROSS MEDIUM- AND LONG-TERM CREDIT AND VOLUME OF BUSINESS^a OF
THE SYSTEM IN THE CAPITAL MARKET, 1974-1976**
(IL million)

	1974	1975	1976
1. Gross medium- and long-term credit	4,720	6,790	8,330
2. Financial dealings within the system (revenues)	6,000	9,730	11,930
3. Financial dealings of the system with other sectors (revenues)	12,050	18,320	23,730
4. Total volume of financial business (revenues)(2+3)	18,050	28,050	35,660
5. Ratio between gross credit and total business volume of the system (1/4)	26	24	23

^a Only includes business connected with the granting and receipt of financial means for the medium and long term.

SOURCE : Estimates of the Research Department, Bank of Israel.

The government's financial relations with the system are quite complex. Essentially they fall into four categories (see Table XVIII-4).

(1) Part of the system's resources flows to the government in the form of financial institution deposits of some of their bond issue proceeds and sales of government bonds to various segments of the system (see column 4).

(2) The government places deposits with the system's secondary financial intermediaries for granting loans in conformity with its guidelines (column 5).

(3) The government repays linked debts to the system, mainly those mentioned in section 1 (column 1).

(4) The system makes repayments to the government on account of the latter's assets held with it, mainly those mentioned in section 2 (column 2).

In 1976, government absorption from the system declined, reaching IL 910 million, as compared with IL 1,660 million last year. Part of this decline is the result of advanced acquisition of securities by the system's primary intermediaries towards the end of last year (in expectation of capital gains due to the worsening of the terms of new securities). This development increased the absorption last year beyond the expected level, and then caused the decrease this year. In addition, this decrease is an expression of the government policy to moderate the restraints on the economic sectors, derived from the drop in household savings and other developments affecting the system's credit resources.

In the receipts and payments account of the assets and liabilities situation, the government constitutes a large supplier of net resources to the system (IL 3.5 billion per year), especially as a result of the gap between the system's deposit terms with the government (index linkage parallel to the liabilities that the system undertook) and the government's deposit terms with the system (low interest without linkage, parallel to the terms of interest on loans granted by the system to the economic sectors). On the other hand, in the current receipts and payments account, deriving from ongoing activities, the government has absorbed considerable resources from the system (IL 4.4 billion this year), and the net result is a government absorption of IL 900 million.

e. Industrial and Agricultural Credit

During 1976, industrial credit increased at a slower rate than last year, but in view of the steeper slowdown in the rate of investments, there was a considerable rise in the financing rate; from 44 percent last year to 58 percent this year.

Total medium- and long-term credit for industrial financing²⁰ grew by 44 percent this year, as compared with 76 percent last year, totaling IL 2,380 million. The scope of investments in industry increased this year (in nominal terms) by 10 percent, as com-

²⁰ Medium- and long-term credit extended through the institutional system of the capital market. Quite often, businesses obtain medium- or long-term credit from abroad (with Treasury exchange-rate insurance) through the commercial banking system, and therefore this credit is not included here. Since this phenomenon mainly characterizes public sector companies, and the weight of these companies in investments grew this year, it can be assumed that financing from abroad, not included in the system, also grew.

pared with 71 percent last year, and amounted to IL 4,120 million. In real terms, this represents a decline in investments this year, at a rate of 11 percent, as against a 19 percent rise last year.

TABLE XVIII-6

INDUSTRIAL INVESTMENT CREDIT, 1973-1976

(IL million)

	Gross medium- and long-term credit granted (1)	Industrial investment, at current prices (2)	Ratio of credit to investment (%) (1/2) (3)
1973	820	1,650	50
1974	940	2,180	43
1975	1,650	3,730	44
1976	2,380	4,120	58

SOURCE : (1) Table XVIII-I; (2) Chapter VIII.

TABLE XVIII-7

AGRICULTURAL INVESTMENT CREDIT, 1973-1976

(IL million)

	Gross medium- and long-term credit granted (1)	Agricultural investment, at current prices, excl. land reclamation, afforestation and drainage (2)	Ratio of credit to investment (%) (1/2) (3)
1973	387	385	100
1974	490	550	89
1975 ^a	630	900	70
1976	850	1,090	78

^a Revised data.

SOURCE : (1) Table XVIII-I; (2) Chapter VIII.

The considerable increase in the rate of investment financing in industry is surprising, since there were no changes in the formal criteria for financing domestic investments. One must regard the investment data, which may be underestimated, with care. In addition, in a year of steep declines in investments, the lag between the execution of the investment and the date of granting the credit may raise the measured annual rate of financing. However, the considerable rise in the rate of financing investments was still outstanding, while no significant change in the regional structure of investments was apparent. A small part of this rise resulted from specific decisions, regarding certain sectors or financing frameworks, to raise the rate of financing beyond the accepted criteria, but that is a minor factor which may explain only 5 percent of the increase in the financing rate.

Taking into account the above-mentioned uncertainties, it seems that this year there was a considerable rise in the average financing rate of industrial investments; this may be due, to a great extent, to credit granted at especially high rates to a small number of large, special projects.

The situation of agricultural credit is similar to that of industry, though not as intensive: medium- and long-term credit grew by 35 percent this year, as compared with 29 percent last year, totaling IL 850 million. The growth rate of investments in agriculture²¹ slowed down sharply (21 percent, as against 64 percent last year), and as a result the financing rate increased from 70 percent last year to 78 percent this year.²² It should be emphasized that the rate of agricultural investment financing is affected by considerable fluctuations from one year to another. This may at least partially derive from changes in the volume of credit extended directly by the public sector.

The agricultural credit discussed here is mostly cheap credit extended by a limited group of institutions, specializing in financing agriculture under guidelines of the Ministry of Agriculture and the Jewish Agency. The criteria for extending this credit ensure that priority investment activities are granted financing of up to 90 percent of the investment. Because of the complexity of the framework through which it is granted, it is possible that in the end some investment plans benefit from a financing rate that in fact exceeds the declared criteria. In addition, some of the amounts granted to farmers in concentrated credit and other frameworks, may have been primarily intended to finance other economic activity of the farms (building not intended for agriculture, acquisition of durables, etc.). Furthermore, part of the credit may not have been intended to finance investments from the beginning, but was granted to fill needs of working capital and/or enable a consolidation of debts connected with past investments in the sector.

²¹ Excluding investments for land preparation, afforestation, and drainage, which are mainly direct investments of the public sector.

²² Another expression of the rise in financing rates is obtained by comparing the real rates of change in credit and investment: a rise of 8 percent in the former against a 3 percent drop in the latter.

The hidden subsidy in agricultural credit is much higher than in industrial credit, in spite of the fact that the interest terms are similar. The difference lies in the length of the loan period (generally more than 17 years, in contrast to 8 years in industry), which causes the subsidy to be especially sensitive to the price increase trends.

f. Credit to the Rest of the Economy

In contrast to agriculture and industry, the dependence of the building and service sectors on the institutional system of the capital market is rather small. This situation is to a great extent due to the fact that these sectors are lower on the scale of preferences of the authorities controlling the credit (excluding tourism, and especially investment in hotels). As a result, these sectors use their own resources, credit from commercial banks, or credit from abroad.

In 1976, the scope of medium- and long-term credit extended to the construction and service sectors dropped by 16 percent in nominal terms, amounting to IL 1,050 million, as against a sharp rise last year of 95 percent. This may indicate not only a slowdown in activity, but also a return to the customary financing system. On the other hand, there are signs that this year there was an increase in short-term credit (up to two years) extended to the construction sector from public sector money, in order to finance the large inventory of unsold apartments, mainly in development areas and other settlements not in demand.

Credit to services decreased from IL 910 million last year to IL 810 million this year, which was especially due to the decline in the volume of financing through the system to the tourism branches (mainly hotel construction, which declined considerably this year) and electricity. Credit to the construction sector also declined from IL 340 million last year to IL 240 million this year, but since the weight of financing through the system in total sector financing is limited, it does not indicate the total financing needs of the sector, which may even have increased this year following the accumulation of a large inventory of apartments by the building companies.

TABLE XVIII-8
SOURCES AND USES OF SOCIAL INSURANCE FUNDS, 1974-1976
 (IL million)

Sources	1974	1975	1976	Uses	1974	1975	1976
Net savings deposits ^a	1,505	1,735	2,162	Net transfers ^b	1,256	1,625	1,948
Repayment of medium- and Long-term loans	200	253	310	Medium- and long-term credit granted	308	306	356
				Short-term uses, net ^c	62	28	(- 2)
				Surplus of expenditure over income	48	49	159
				Net change in cash balances and demand deposits	31	(-30)	11
Total sources	1,705	1,988	2,472	Total uses	1,705	1,088	2,472

NOTE: Receipts from medium- and long-term debt repayment, savings withdrawals, and redemption of securities consist not only of the principal but also interest and linkage differentials paid. In the flow-of-funds system these components were formerly defined as real (i.e. nonfinancial) transactions and included in the surplus of income over expenditure. In the present system the "surplus of expenditure over income" consists, in addition to payroll, service charges, purchase of real assets, etc. only of interest received and paid on short-term credit transactions.

^a Net of withdrawals and assuming that contributions to severance pay schemes are treated as part of household saving.

^b Consists predominantly of net purchases of securities.

^c The increase in outstanding short-term assets, less the increase in outstanding short-term liabilities.

SOURCE : Estimates of the Research Department, Bank of Israel.

II. COMPONENTS OF THE CAPITAL MARKET

1. SOCIAL INSURANCE FUNDS²³

a. Income and Outgo

In 1976, the real flow of revenues²⁴ of the social insurance funds dropped by 5 percent (see Table XVIII-8). This drop reflects a real decline of 5 percent in saving deposits, which are the major component of resources in the sector, and a greater decline (7 percent) in revenues from repayment of medium- and long-term loans, which is a secondary resource.

Savings deposits will be discussed at length in the next section. The repayment of loans has been far behind price increases in the economy for many years. This is because credit extended by the sector to households (the main borrower from the sector) was partly unlinked and partly linked only indirectly to the price index; linkage profits are not credited to the savings of the borrower, and they are not actually paid upon the repayment of the loan.

1. Savings Receipts

Accumulation of savings in social insurance funds increased by 25 percent in 1976²⁵ (15 percent in 1975, see Table XVIII-9). This represents a considerable slowdown in

²³ The structure of the sector and the nature of its activities is described in the Appendix to this Report and in the Bank of Israel Annual Report 1975, pp. 417-419. In the tax year 1976/1977, the tax authorities introduced several changes affecting the flow of revenues to the social insurance funds, as follows:

A. The ceilings on tax deductions and credits for social insurance fund accounts for purposes of calculating income tax were brought up to date:

	1975/76	1976/77
1. maximum allowance the self-employed can deduct from their taxable income	3,500	3,850
2. maximum allowance an employee can deduct if he has no pension or provident arrangement with his employer	2,500	2,750
3. 25 percent tax credit in addition to the above-mentioned deductions	2,500	2,750

B. Ceiling of deposit which receives the maturity of the account into which it is deposited

	9,600	12,000
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C. The required rate of investment in securities was raised from 89 percent at the end of 1975 to 92 percent at the end of 1976.

D. At the end of 1976 the interest rate on bonds issued to the social insurance funds was reduced by one percent. Seventeen-year bonds for provident and severance pay funds would bear 5 percent interest in the future. Twenty-year pension fund bonds would bear 5.5 percent interest.

²⁴ Discounted by the annual average of the Cost-of-Living Index.

²⁵ The 1976 increase in net accumulation had been previously confirmed by the Central Bureau of Statistics.

TABLE XVIII-9

FLOW OF SAVINGS, BY TYPE OF FUND, 1974-1976

	1974	1975	1976	Annual change		
				1974	1975	1976
	(IL million)			(percent)		
Deposits						
Pension ^a	1,037	1,438	1,924	40	39	34
Provident ^b	1,182	1,481	2,126	93	25	44
Severance pay ^c	192	213	248	37	11	16
Mixed and other	60	107	107			
Total	2,471	3,239	4,405	61	31	36
Payments						
Pension	630	914	1,312	36	45	44
Provident	210	414	670	87	97	62
Severance pay	97	148	218	120	53	47
Mixed and other	29	28	43			
Total	966	1,504	2,243	50	56	49
Net accumulation						
Pension	407	524	612	46	29	17
Provident	972	1,067	1,456	94	10	36
Severance pay	95	65	30	(-1)	(-31)	(-54)
Mixed and other	31	79	64			
Total	1,505	1,735	2,162	70	15	25

^a Funds administered by the Histadrut (General Federation of Labor), companies, and commercial banks.

^b Bank-administered and company provident funds and advanced study schemes.

^c Bank-administered central pay funds and company funds.

^d Company funds administering provident and severance pay schemes combined and paid-vacation schemes.

SOURCE: Estimates of the Research Department, Bank of Israel.

the real decline of the annual accumulation flow: 5 and 17 percent in 1975 and 1976 respectively. The increasing accumulation in the provident funds operated by the commercial banks is noteworthy. This accumulation (IL 1.5 billion) was about two-thirds of the accumulation of the entire sector. The rise in pension fund accumulation,

which was contrary to the decline in accumulation of other components of the sector, derived from an increase in the growth rate of deposits, as well as a decrease in the growth rate of withdrawals.

Allocations to the pension funds are closely connected with wage payments in the economy, whereas allocations to the provident funds contain an element of capital investment connected with capital market developments. Public demand for direct holdings of bonds dropped in 1976, as did the acquisition of participation certificates in mutual funds. This was a result of the intensifying public fear of bond values being affected by government policy measures taken at the end of 1975 and the lowering of return on them. On the other hand, the public increased its deposits in provident funds.

The transition from savings in bonds to deposits in provident funds requires an explanation. Seemingly, the provident fund accounts are not liquid, since the amounts are deposited for fifteen years, but in fact this is not so. Deposits from social insurance fund transfers — such as redeemed directors' insurance (after 10 years), workers' severance pay or payments after death — assume the maturity accumulated by the deposits in the account they came from.

Deposits up to IL 12,000 in social insurance funds also benefit from the accumulated maturity of the account (from the day of its opening). Inevitably, as time passes and social insurance funds grow, the number of accounts approaching maturity will increase. Therefore it is reasonable that many deposits in provident funds are liquid, and this increases the attraction of depositing in those funds. It should be noted that new provident fund accounts for people over 60 are frozen for only 5 years, and are therefore preferable to deposits in savings programs which require a six year saving period.

Together with the increase of provident fund deposits in 1976, there was a halt in the rise of withdrawals from the funds. The increase in withdrawals was 62 percent as against 97 percent in 1975. Apparently the alternatives seemed less desirable than the continuation of saving in matured provident fund accounts; the declining attraction of bonds is the other cause of this development. The increase in deposits and slowdown in withdrawals caused the net accumulation to grow by 36 percent in 1976 (4 percent in real terms).

Allocations to pension funds are tied to business sector labor agreements and the scope of wage payments, and are less affected by the propensity to save and changes in the capital market. Gross deposits in pension funds of the business sector²⁶ grew by 34 percent in 1976 (compared to an estimated rise in wages of 36 percent), which represents a real increase of one percent. The growth rate of pension fund payments was similar to that of last year. The real increase in withdrawal was 9 percent, which derived from wage increases and the aging of pension fund members. The net accumulation nominally increased by 17 percent (a real decrease of 11 percent).

²⁶ It should be emphasized that there is no identity between wages and the basis for calculation of allocations or withdrawals from the pension funds.

Following the trend of recent years, the slowdown in the net accumulation of severance pay funds continued in 1976; the accumulation in 1976 reached IL 30 million (IL 65 million in the previous year).

2. Use of Funds

Securities acquisitions are the major investment of the social insurance funds. In 1976, their share reached 94 percent of the net saving accumulation in the sector (an increase of one percent as compared with last year). This resource allocation is determined according to the regulation of the controlling authority. Obligatory investment in securities, classified by the regulations as "recognized investment", was increased from 89 percent of the total assets at the end of 1975, to 92 percent at the end of 1976.²⁷ This increase of 3 percent requires a much larger current investment in securities, relative to this year's net accumulation. For this reason the extension of medium- and long-term credit decreased in real terms in 1976 (as in 1975).

In 1976, the social insurance funds continued to concentrate their investments in securities issued by financial institutions to the detriment of those issued by other bodies. This corresponds to the propensity of the social insurance funds to acquire securities of financial institutions belonging to the financial concerns of which they are a part.²⁸

The sector's activity in extending credit is most limited. Within the framework of the controlling authority directives regarding the funds' investments, medium- and long-term credit reaches 14 percent of the sector's flow of payments. Most of this credit is extended to households on "indirect linkage" terms, and in 1976 this credit showed a net growth of 19 percent. Net credit to businesses, local municipalities and others, as well as deposits, all declined.

b. The Combined Balance Sheet of the Social Insurance Funds²⁹

The above discussion concentrated on flows, whereas this discussion will focus on the balance sheet, in which the aggregate influence of flows over the years is reflected.

²⁷ The increased investment in securities is gradual, and the funds must invest their current accumulation in recognized securities until they reach the required rate. During 1975 as well, the required investment rate rose by 3 percent.

²⁸ The uses made by these institutions of the funds mobilized through securities are dictated by the authorities.

²⁹ It should be stressed that in Table XVIII-9 the classification is according to fund, while in Table XVIII-10 the classification is according to reserve. Only the data in the following comment are based on the balance sheet data classified according to fund. The analysis according to classification of reserve seems preferable, but the data above are nevertheless classified according to funds, because of problems related to the revaluation of the various reserves and the possibilities of transferring resources from one reserve to another.

The balance sheet of the social insurance fund grew in 1976 by 56 percent (13 percent in real terms), and reached IL 40 billion (see Table XVIII-10).³⁰

The major asset of the social insurance funds is securities; their revaluated balance is 93 percent of the sector's assets. The share of securities in the total balance sheet has increased over the years, both due to the controlling authorities' requirement and the rise in the alternative price of this investment. In 1973, for example, the rate of invest-

TABLE XVIII-10

COMBINED BALANCE SHEET OF THE SOCIAL INSURANCE INSTITUTIONS,
1975-1976

	1975	1976	Share of item in total balance	
			1975	1976
	(IL million)		(percent)	
Assets				
Securities	22,870	36,351	91.0	92.6
Members' loans	883	1,016	3.5	2.6
Other deposits and loans	596	815	2.4	2.1
Fixed assets	173	240	0.7	0.6
Employers' debt (including bonds)	157	250	0.6	0.6
Assets subject to interest and linkage	256	371	1.0	0.9
Other current assets	206	234	0.8	0.6
Total assets	25,141	39,276	100.0	100.0
Liabilities				
Pension fund	11,281	17,861	44.9	45.5
Provident fund (and advanced study schemes)	9,751	15,506	38.8	39.5
Severance pay fund	2,734	3,923	10.9	10.0
Social and mutual funds	547	595	2.2	1.5
Dues and reserve fund	18	48	0.1	0.1
Aid fund and profit balance	663	1,185	2.6	3.0
Current liabilities	147	158	0.6	0.4
Total liabilities	25,141	39,276	100.0	100.0

^a Revaluation differentials are in the relevant items in the balance sheet.

SOURCE : Central Bureau of Statistics.

³⁰ About 51 percent of this amount in pension funds, 37 percent of the sector's balance sheet — in the balance sheet of funds administered by commercial banks.

ments in securities was only 88 percent (as compared with 93 percent this year), a rate which exceeded the controlling authorities requirements. The reasons are as follows: (a) The required rate is calculated according to non-revaluated asset surplus. (b) In calculating the rate of investment, certain items are not included, the largest being loans granted to members from the assistance fund. (c) Some investments are made in securities not recognized by the controlling authority.

Another investment of the social insurance funds is loans and deposits, which constitute about 5 percent of the sector's assets, most of it in loans to members; the share of this investment in the total assets of the funds has been declining in recent years (in 1973 it was about 8 percent). This declining trend complements the above-mentioned upward trend in investments in securities. The weight of provident funds in the total assets of the sector also contributed to this end. The propensity of those funds to grant loans to their members is probably lower than in other funds.³¹

Examination of the liability side of the sector's balance sheet shows a real growth of 15 percent in the pension and provident funds, whereas the severance pay fund grew in real terms by only 4 percent and its weight in the sector dropped. It should be emphasized that the liability presented in the balance sheet as "pension reserve" does not measure the contingent liability of the funds, because of members' rights. These funds are also entitled to transfer amounts from provident reserves to pension reserves and vice versa, which is not so in the social insurance and severance pay funds, in which there is an arithmetic accounting of members' rights. However, it is possible that some funds tend more to credit profits to the pension reserve and less to the provident reserve.³²

2. INSURANCE COMPANIES³³

a. Income and Outgo of the Life Insurance Branch

Premium revenues from life insurance increased this year by 40 percent, totaling IL 910 million. This is a real increase of 7 percent as against one percent last year, and 12 percent in 1974. This development occurred in spite of the decline in the growth rate of the insurance sums (from about 80 percent in 1975 to 55 percent this year)

³¹ When the bank with which the provident funds is connected assists in granting loans to members. The share of the loans to members is 1.7 percent in the balance sheet of the bank funds, and 2.6 percent in the balance sheet of the entire sector.

³² Whereas a calculation not based on revaluation of the funds indicates a decline in the weight of the pension fund in the sector and an increase in the weight of the provident fund. The revaluated calculation (first made for the years 1975-1976) does not show such a trend.

³³ For the structure of the industry and the nature of its operations, see the Appendix and Bank of Israel Report 1975, pp. 422-423.

resulting from the considerable increase in insurance and savings sums within this framework, and from growth in the frequency of adjustments of premiums to the rate of price increases (for linked insurances). This step was taken following the transition to monthly adjustments of the price index for the purpose of insurance companies' bond investments.

Saving through insurance companies has one of the lowest levels of liquidity in the entire range of financial savings possibilities, and it does not give an adequate compensation in the return. Today the individual insured cannot acquire linked life insurance without the saving element. Without this restriction, the sums saved through life insurance would probably decline drastically, or alternatively, the return on these savings would increase significantly.

Interest and capital gain revenues from investments in life insurance increased by 31 percent in 1976, as against 69 percent last year, reaching IL 985 million. This drop in the growth rate of income from capital derived partially from the slowdown in the rate of

TABLE XVIII-11
INCOME, OUTGO, AND ACCUMULATION OF LIFE INSURANCE
COMPANIES IN ISRAEL^a, 1974-1976
(IL million)

	1974 ^b	1975 ^b	1976
1. Income			
Premiums	454	649	911
Interest	96	154	185
Total	550	803	1,096
2. Outgo			
Benefits to policyholders	136	212	287
Agents commissions	56	91	130
Other operating expenses	57	87	122
Gross profit ^c	34	66	84
Total	283	456	623
3. Surplus of income over outgo (1-2)	267	347	473
4. Income from investment of life insurance funds	347	596	800
5. Annual accumulation (growth of the life insurance reserves (3+4))	614	943	1,273

^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 an earlier survey of the Central Bureau of Statistics.

price increases used for revaluating the insurance companies' balance sheets,³⁴ from 40 percent in 1975 to 30 percent in 1976, and partially from a decline in the growth rate of insurance reserves. However, the datum on capital gains is somewhat questionable, since it is residually calculated, and all errors are drawn into it.

The decline in the growth rate of insurance sums pertaining to new transactions was followed by a decline in the growth rate of agents' commissions, which are especially high in the first insurance year; these commissions rose by 43 percent this year, and amounted to IL 130 million.

Claims payments rose by 35 percent in 1976, as against 56 percent last year, and amounted to IL 287 million. In 1975 their growth rate was especially high and was attributed to payments of pending claims which had accumulated during 1974.

To summarize, the current accumulation, excluding capital gains on investments, grew by 36 percent in 1976, amounting to IL 473 million, as against a growth of 30 percent last year. This development derived from a certain decline in the growth rate of revenues which was more than balanced by a sharp decline in the growth rate of payments. With the addition of the higher value of investments, the accumulation in life insurance reached IL 1,270 million, as compared with IL 940 million in 1975.

b. Income and Outgo of the General Insurance Branch

Premium revenues from general insurance increased by 39 percent in 1976, as against 43 percent last year, and amounted to IL 2.4 billion. Developments in the components of general insurance were slightly different this year: premium revenues from motor vehicle insurance increased this year by 63 percent, as against 45 percent last year, and premium revenues from the other general insurance branches increased by 22 percent, as against 41 percent in 1975. These different development trends derive from the implementation of a new accident insurance law towards the beginning of the last quarter of the year. The law caused a considerable increase in premium payments, which were collected in advance towards the last month of the year, for the entire next year. In contrast, the decline in the growth rate of premiums in the other general insurance branches derives from a slowdown in the growth rate of the annual average price level, and partly from the accumulating influence of the slowdown in economic activity, especially the decrease in inventories held by the various businesses.

c. Balance Sheet of Israeli Companies

The combined balance sheet of the Israeli insurance companies increased this year by 48 percent, and amounted to IL 7 billion. This nominal growth rate is lower than last

³⁴ They revalue their balance sheets from June to June, and not from December to December.

year's (about 54 percent) due to the lower rate of linked assets revaluation this year: 30 percent against 40 percent last year. In real terms, the balance sheet increased this year at a slightly more rapid rate than in 1975.

TABLE XVIII-12

GENERAL INSURANCE PREMIUM RECEIPTS^a, 1974-1976

	1974 ^b	1975 ^b	1976
	(IL million)		
Total general premium receipts	1,216	1,736	2,409
Motor vehicle insurance	483	701	1,142
Other insurance	733	1,035	1,267
	(percent)		
Annual increase in premium receipts			
Total general insurance	36.8	42.7	38.8
Motor vehicle insurance	35.9	44.9	62.9
Other insurance	37.3	41.2	22.4

^a Of Israeli and foreign companies and Lloyd's agents, includes registration fees; excludes reinsurance in Israel.

^b Revised data.

SOURCE: Bank of Israel calculations based on an earlier survey of the Central Bureau of Statistics.

The fact that the weight of securities in the total assets amounts to 57 percent (in spite of the delayed revaluation), and the weight of insurance funds (including pending claims) amounts to 77 percent of total liabilities, indicates that the insurance companies are basically primary financial intermediaries, though to a lesser extent than those in the social insurance framework.

Because of the nature of their activity and rules of competition between them, the volume of short-term uses in the means at their disposal exceeded that of the provident fund sector. "Other loans", "outstanding premiums", and "sundry debtors", which are short-term asset items, increased this year by 43 percent, amounting to IL 2 billion. The major component, in both the balance and the increase is the "other loans" item which includes short-term loans to various bodies in the economy. These loans increased by 85 percent this year as against 74 percent in 1975, and against an increase of 48 percent in the total balance sheet. The continuing rapid growth of short-term credit extended by the insurance companies on commercial terms expresses the need in the money market during the year, and the intensifying requests to insurance companies for short-term credit, as against a relative slow increase in the short-term credit extended by the commercial banks.

On the assets side, the weight of the linked securities portfolio increased and reached 57.2 percent. In contrast, the decline in the weight of "outstanding premiums" and "sundry debtors" declined, apparently because of the rise in interest rates and the increase in alternative prices of these items. It should be noted that the declining trend in the weight of reinsurer deposits within the total balance sheet accelerated. This development derived from the increase of self- and Israeli-retention as opposed to sub-insurance abroad. This development is especially outstanding in the motor vehicle branch as a result of the incorporation of a joint company of all insurance companies, which issues the obligatory insurance under the new law. In this company the percentage of retention is especially high, though it exists, to a lesser extent, in other general insurance branches.

TABLE XVIII-13
ASSETS AND LIABILITIES OF ISRAELI INSURANCE COMPANIES, 1974-1976

	1974 ^a	1975 ^a	1976	1974 ^a	1975 ^a	1976
	(IL million)			(percent)		
Assets						
Government or government guaranteed bonds	1,573	2,600	3,997	51.3	55.0	57.2
Other securities	61	84	95	2.0	1.8	1.4
Loans on policies	38	49	72	1.2	1.0	1.0
Other loans	322	560	1,038	10.5	11.9	14.8
Long-term deposits	69	73	111	2.2	1.5	1.6
Real estate and investment in subsidiaries	136	181	214	4.4	3.8	3.1
Outstanding premiums	307	455	593	10.0	9.6	8.5
Sundry debtors	274	360	340	9.0	7.7	4.9
Cash and demand deposits	288	361	530	9.4	7.7	7.5
Total assets	3,068	4,723	6,990	100	100	100
Liabilities						
Paid-up share capital	115	166	205	3.7	3.5	2.9
General and other reserves	148	213	302	4.8	4.5	4.3
Life insurance reserve (less reinsurance)	1,426	2,335	3,515	46.5	49.4	50.3
General insurance reserve (less reinsurance)	265	370	765	8.6	7.8	10.9
Extraordinary risks reserve	106	155	232	3.5	3.3	3.3
Deposits of reinsurers	201	274	298	6.6	5.8	4.3
Pending and approved claims	544	823	1,123	17.7	17.4	16.1
Current liabilities	263	387	550	8.6	8.3	7.9
Total liabilities	3,068	4,723	6,990	100	100	100

^a Revised data.

SOURCE: Bank of Israel calculations based on an earlier survey by the Central Bureau of Statistics.