CHAPTER XVI

FLOW OF FUNDS

1. Main Developments

The rapid expansion of economic activity in 1968 was a product of the stronger demand in the principal nonfinancial sectors: the private and public sectors and public sector companies. This contrasts with the situation in the previous year, when the growth of the public sector's demand surplus offset the contractionary effect of the cutback in investment by the private sector and public sector companies.

Nearly all of the incremental private sector demand in 1968 (reflected by a decline in the sector's supply surplus) was accounted for by businesses, following a decrease in 1967, whereas the supply surplus of households apparently did not change to any marked degree. The demand surplus of businesses was an outcome of their much higher level of capital expenditure, which was only partly financed out of increased gross business saving. The household supply surplus held steady, reflecting the steep rise in incomes, which was accompanied by an increase in purchases of durable consumer goods, in consumption, and in investment in housing.

The public sector demand surplus expanded only slightly in 1968, after soaring in the previous year because of the war and heavier defense spending. The demand surplus of public sector companies went up appreciably as the result of a much larger investment, following a marked decline in 1967. The nonprofit institutions showed a slight drop in their demand surplus, continuing the trend of the previous year.

The swelling demand surpluses of business, the public sector, and public sector companies, which were not accompanied by a corresponding growth in the household supply surplus, increased the importance of the rest-of-the-world sector in financing the aggregate domestic demand surplus; that is to say, the balance of payments deficit on current account widened. The growth of the foreign sector's supply surplus (the economy's import surplus) was accompanied by the large-scale receipt of net short-term credit from overseas sources by the domestic sectors (including the decline in the economy's foreign exchange reserves). This development is explained by the smaller inflow of long-term capital from abroad—a decrease in foreign unilateral transfers and in long- and medium-term credit.

The public sector financed its demand surplus by borrowing from the banking system and mobilizing capital abroad. This inflationary financing was the main cause of monetary expansion in 1968. The same was true of 1967, but then such financing helped to stimulate the recovery of the economy, which was suffering from widespread unemployment.

The amount of credit provided by the public sector to the other domestic sectors was a little above the previous year's level, but its composition underwent a change, which increased the expansionary influence of the sector's credit transactions. Long-term lending, intended predominantly for financing investments, rose steeply, but there was no increase in long-term funds mobilized; in fact, Government bond issues and Absorption Loan collections (which have a strong restrictive effect due to the compulsory nature of this loan) even declined. There was an increase in short-term borrowed receipts, chiefly suppliers' credit.

Household purchases of financial assets underwent a structural change in 1968: the relative shares of less liquid deposits with banking institutions, the Short-Term Loan, and currency and demand deposits went up, while that of Government bonds—in the main the Absorption and Defense Loans—declined. Household and business accumulation in social insurance funds and insurance companies was slightly larger in the year reviewed, owing to the growth of employment and wage outlay.

The demand surplus of the business sector in 1968, which followed a supply surplus the year before, was reflected by a much heavier borrowing from the banking system and financial institutions in order to finance the sector's increased capital spending, and apparently also to enlarge its working capital.

The banking system granted much more credit to the nonfinancial sectors in 1968. The much larger volume of Bank of Israel credit to the public sector resulted in a strong monetary expansion and permitted a noticeable expansion of bank credit to business, despite the contractionary measures introduced by the Bank of Israel in May.

The amount of funds mobilized by financial institutions rose in 1968, owing to the larger issue of bonds, which were purchased chiefly by social insurance funds and banking institutions, and to the receipt of various types of deposits from banking institutions. In 1968 the financial institutions were not net borrowers from the rest-of-the-world sector but net lenders, repaying credits provided by foreign investors. The bulk of the credit granted by the financial institutions went to businesses and households, primarily for financing investments and home purchases. Part of the increased lending to the private sector was at the expense of the public sector, which received less institutional credit than in 1967.

The accumulation in social insurance funds and insurance companies (the principal form of contractual saving in Israel) was somewhat higher in 1968 than in the previous year. Part of the funds flowed to financial institutions and the public sector, by way of purchases of bonds issued by these sectors, and part was deposited in banks for loan purposes.

2. Conceptual Framework[1]

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

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

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

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

(c) Domestic financial sectors—the banking system (banking institutions and the Bank of Israel), financial institutions (mainly mortgage and development banks and investment companies), social insurance funds, and insurance companies. The principal function of the financial sectors is to lubricate the saving and investment processes, and our interest lies primarily in the composition of the sources and uses of their funds.[4] These sectors include the following:

1. The banking system: This sector has one characteristic that distinguishes it from the other financial sectors, namely, the fact that a large percentage of its liabilities constitute means of payment. Whereas the other financial sectors can grant credit only if they have raised funds from the other sectors, the banking system is not subject to this constraint. By providing credit it creates means of payment, which are classified in the flow-of-funds system as

[1] A detailed description of flow-of-funds analysis can be found in M. Heth, *Flow of Funds in the Israeli Economy, 1959–66*, Bank of Israel, Jerusalem (English edition forthcoming).

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

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

[4] In general, flows of funds through the financial sectors are ignored when the financial intermediary is not at liberty to decide on their allocation. For example, credit granted from earmarked Government deposits is not considered as flowing through the financial sectors, but is recorded as going directly from the public sector to the borrowing sector. Because of statistical difficulties, it is not possible to isolate all such flows, and some of them are recorded as passing through the financial sectors.

a source of funds, although they differ essentially from the sources of the other financial sectors.

2. Financial institutions: This group of financial intermediaries operates chiefly in the long-term credit market, raising most of its funds by selling bonds to social insurance funds and obtaining credit from the banking system.[1] These sources of finance are largely directed by the Government, which regulates their volume and determines their price and allocation. Most of the funds provided by this sector are long-term credits for financing business investment and the purchase of dwellings by households.

In addition to the above-mentioned sources, a large percentage of the public sector's deposits earmarked for the granting of credit to the various sectors of the economy are deposited with these institutions; the latter are responsible for the technical arrangements connected with the granting of the credit and the collection of the principal and interest, but do not determine their allocation. As stated, these are not included in the credit-flows data for this sector.

3. Social insurance funds and insurance companies: This sector is the principal channel for contractual savings in Israel; it raises the bulk of its funds from households and invests them in bonds. Such investment is subject to Government control, thereby largely negating the status of this sector as an independent financial intermediary. Because of the significant role of social insurance funds and insurance companies in the capital market, the Government's direction of their investments renders this the principal instrument for controlling the bond market. The social insurance funds must invest at least 80 percent of their accumulation in securities approved by the Treasury (half of this approved investment is channelled to Histadrut enterprises and institutions). Most of the investment of insurance companies is in securities issued by the Government and public sector companies.

This sectoral classification is essentially different from that of the conventional system of national accounts. In flow-of-funds analysis the sectoral classification of economic units is according to the characteristics which determine their behavioral pattern (as a rule, field of activity and ownership). The classification in the national accounts is mainly according to the economic function of the units (consumption, investment, etc.).[2]

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

[1] In most of the years for which a flow-of-funds analysis has been made of the Israeli economy, the financial institutions also received net credit from abroad. In 1968 they were net lenders to the foreign sector, debt repayment exceeding borrowed receipts.

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

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

A sector's demand surplus represents the difference between the sector's use of and its contribution to the supply of real resources; hence the demand surplus, and particularly changes therein, indicate the sector's influence on aggregate demand.[1]

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

The second type of flow-of-funds analysis concentrates on various aspects of activity in the capital and money markets and the changes therein, as described in the credit-flows table. This comprehensive presentation of the financial transactions of the individual sector provides us with a "closed" system. It also enables us to derive indirectly the private sector's credit flows, for which no direct data are available.[2]

The usefulness of flow-of-funds analysis is greatly circumscribed because of theoretical and technical problems that have yet to be solved. On the theoretical plane, there is no body of theory comparable, for example, to input-output theory, which is based on a statistical framework with characteristics similar to those of the flow-of-funds structure.

On the technical plane, the analysis is limited by the absence of data per-

[1] A sector's receipts from sales and domestic transfers absorb funds from other domestic sectors, reducing the purchasing power of the latter while correspondingly increasing its own. It should be noted that ex-post data show the *results* of demand pressure. An increase in the demand surplus of a sector does not necessarily mean that it originated in the sector itself: the demand surplus of a sector is likely to increase with a rise in its expenditure, while the demand pressure which pushed up prices and costs may have originated in other sectors. This problem of interpreting ex-post data also exists in the conventional analyses of national product determination.

[2] The system permits the segregation of household credit flows from those of the business sector.

mitting the segregation of the nonfinancial transactions and part of the financial transactions of businesses from those of households. This deficiency is particularly serious in view of the dissimilar nature of these two sectors and their substantial weight in economic activity. Another shortcoming is the lack of direct data on their activities. Data thereon are derived from the flow-of-funds statements of the other sectors, and in part are residual estimates. Hence they are liable to be heavily biased.

3. Demand Surpluses of the Nonfinancial Sectors

The marked expansion of economic activity in 1968 was a result of the increased demand of the three major real (nonfinancial) sectors. The most outstanding rise was in the private sector, its supply surplus declining from IL 780 million in 1967 to IL 250 million. The demand surplus of the public sector increased from IL 2,160 million in 1967 to IL 2,290 million, and that of public sector companies from IL 70 million to IL 270 million. By contrast, the nonprofit institutions showed very little change in their demand surplus, which amounted to IL 200 million—slightly below the 1967 figure.

The fall in the private sector's supply surplus, which reversed the trend of 1965–67, was due primarily to heavier investment, and to a lesser extent to the much stronger demand for housing, durable goods, and current consumption which accompanied the economic recovery from mid-1967 onward.

The growth of the private sector demand surplus was not offset by a decline in the demand surpluses of the other nonfinancial sectors; on the contrary, that of the public sector and its companies rose in 1968, as already noted. The increased demand emanating from these three sectors resulted not only in a marked expansion of the national product, but also in a larger import surplus; it likewise led to the re-employment of factors of production that had been idle during the recession.

In 1967 the surpluses of these three sectors had developed in opposite directions. The steep rise in the public sector's demand surplus, an outcome of the much heavier defense expenditure and a fiscal policy designed to stimulate economic activity, offset the big private sector supply surplus (particularly in the first half of the year) and the decline in the demand surplus of public sector companies. The private sector supply surplus was the combined result of a precipitate drop in business investment and home purchases and the growth of both business and household savings—a reflection of the economic forces at work during the recession.

Another deflationary influence in 1967 was, as mentioned above, the steep fall in the demand surplus of public sector companies, this too due to a larger saving and smaller purchases on capital account.

The expansionary effect of the public sector's increased demand in 1967—attributable to the enormous growth of security spending and its deficit financ-

Table XVI-1

DEMAND OR SUPPLY SURPLUSES, BY SECTOR, 1966-68[a]

(IL million)

	Purchases: On current account	Purchases: On capital account	Sales	Net purchases (1+2-3)	Transfers: To domestic sectors	Transfers: From domestic sectors	Net transfers (5-6)	Demand or supply (-) surplus (4-7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Business and households[b]								
1966	—	1,428	—	—	—	—	—	71
1967	—	945	—	—	—	—	—	-784
1968	—	1,544	—	—	—	—	—	-252
Public sector[c]								
1966	3,053	642	589	3,106	1,067	3,263	2,196	910
1967	4,113	503	574	4,042	1,283	3,169	1,886	2,156
1968	4,714	620	734	4,600	1,592	3,902	2,310	2,290
Public sector companies[d]								
1966	926	343	1,046	223	16	40	24	199
1967	1,199	307	1,396	110	15	52	37	73
1968	1,511	580	1,814	277	30	38	8	269
Nonprofit institutions[e]								
1966	794	160	207	747	24	550	526	221
1967	866	149	220	795	26	609	583	212
1968	924	160	234	850	27	676	649	201
Social insurance funds and insurance companies[f]								
1966	214	13	222	5	192	224	32	-27
1967	231	10	278	-37	252	226	-26	-11
1968	267	7	315	-41	301	265	-36	-5
Banking system[g]								
1966	437	13	526	-76	70	—	-70	-6
1967	495	14	602	-93	91	—	-91	-2
1968	618	31	789	-140	103	—	-103	-37
Financial institutions[h]								
1966	238	7	292	-47	38	—	-38	-9
1967	288	-4	342	-58	40	—	-40	-18
1968	334	3	415	-78	47	—	-47	-31
Rest of the world[i]								
1966	2,496		3,855	-1,359	—	—	—	-1,359
1967	2,780		4,406	-1,626	—	—	—	-1,626
1968	3,949		6,384	-2,435	—	—	—	-2,435

[a] The 1967 figures have been revised.

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

[c] As defined in Chapter VII, "Government and Non-Government Public Sector", except that here sales include interest received and purchases include interest paid by the National Institutions to the rest of the world. Because of changes in definitions, care should be exercised when comparing data on the sector's demand surplus in 1967 and 1968 with those for previous years (see the explanation in Chapter VII, section 1).

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

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

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

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

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

[i] Sales are identical with imports as recorded in the balance of payments, and purchases are identical with exports.

ing—outweighed the effect of the other developments, and led to the rapid recovery of economic activity in the second half of the year.

A decline in the private sector supply surplus results, by definition, from changes in income and in saving and investment patterns. The available data do not permit a calculation of changes in the supply surpluses of the two component segments.[1] There is reason to believe, however, that businesses and households experienced an opposite development in 1968: there was apparently no change to speak of in the household supply surplus, while the supply surplus generated by businesses in 1967 turned into a large demand surplus in the year reviewed. This was in contrast to the recessionary period (1966 and 1967), when there was a slackening of demand on the part of both businesses and households.

While there is no direct way of quantitatively proving this supposition, partial support for it can be found in the data in Table XVI–2 and in data culled from the financial reports of large firms operating in various sectors of the economy. An indirect estimate of the business sector's surplus, as calculated in Table XVI–2, shows that in 1968 it had a demand surplus whereas in 1967 it ran a supply surplus.[2] The demand surplus in 1968 was similar in size to that in 1966 but lower than in 1965. The data for the household sector indicate that its 1968 supply surplus was about the same as in the previous year.[3] A glance at Table XVI-2 shows that the business sector was primarily responsible for the sharp fluctuations in the demand surplus of the private sector as a whole in 1967 and 1968. In other words, the creation of a considerable private sector supply surplus in 1967 and its decline in 1968 were largely a result of the reduced demand of the business sector in 1967, which was followed by a reversal of trend in 1968.

The growth of business sector demand in 1968 stemmed from the much heavier capital spending. Business saving rose during the year, counterbalancing to some extent the influence of the increased purchases on capital account. This stronger investment demand was one manifestation of the economic recovery, and is discussed at length in Chapter V, "Domestic Investment" (section 2). The growth of gross business saving can be attributed to the much higher level of

1 Besides these statistical deficiencies, there is a conceptual problem in distinguishing between the behavioral patterns of the two subsectors because of the large weight of unincorporated businesses and self-employed persons in Israel's economy.

2 The flow-of-funds system makes it possible to indirectly estimate the sectoral surpluses of each of the two components of the private sector. These are rough estimates and liable to be biased (the direction of the bias is unknown). Hence considerable caution should be exercised when analyzing changes in the surpluses of businesses and households. It should be noted that the indirect estimate is not independent of the residual estimate calculated in Table XVI-1.

3 Table XVI–2 indicates a slight rise in the household supply surplus in 1968, but this estimate is apparently upward-biased. A further indicator—the growth of household income and demand for consumption and investment—also points to stability in 1968.

economic activity in 1968, which was accompanied by a comparatively slow rise in payroll outlay and a consequent increase in business profits. It is reasonable to assume that the growth of profits explains the higher gross saving figure.[1]

According to one indicator, the expansion of the business sector's demand surplus in 1968 did not encompass all the firms, some of them substantially enlarging their financial asset holdings during the year. A breakdown of fixed-term deposits with banking institutions by size shows that in 1968 deposits of over IL 50,000 increased by approximately IL 180 million;[2] part of these deposits presumably belonged to firms investing their surplus liquid assets for short periods. The jump in these deposits leads to the assumption that some of the firms did not immediately step up their capital spending with the onset of economic recovery, but acquired financial assets with the idea of holding them until such time as they were ready to enlarge their plants.

The decline that took place in the business sector's demand surplus in 1967 is shown by the data in Table XVI–2, as well as by the findings of a sample of com-

Table XVI–2

INDIRECT ESTIMATE OF HOUSEHOLD AND BUSINESS SECTOR SURPLUSES, 1966–68[a]

(IL million)

	1966	1967	1968
Households			
Net credit received[b]	76	79	100
Transfer receipts from abroad	577	595	753
(1) Total financial resources	**653**	**674**	**853**
(2) Net credit granted[b]	1,026	1,264	1,513
(3) Indirect estimate of supply surplus (1–2)	**–373**	**–590**	**–660**
Business			
(4) Net credit received[b]	627	353	503
(5) Net credit granted[b]	81	468	24
(6) Indirect estimate of demand surplus (4–5)	**546**	**–115**	**479**
Private sector			
Indirect estimate of demand or supply (–) surplus (3+6)	173	–705	–181
Residual estimate of demand or supply (–) surplus[c]	71	–784	–252
Difference between estimates[d]	–102	–79	–71

[a] Figures for 1967 have been revised.
[b] According to Table XVI–2 in the appendix.
[c] As shown in Table XVI–1.
[d] Identical with errors and omissions for the private sector in Table XVI–3.

[1] See Chapter II, "Resources, Uses, and Incomes", section 5.
[2] See Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 2.

panies operating in different branches of the economy,[1] which permit a direct calculation of the changes in the demand surplus and its components. According to these findings, business investment plummeted 42 percent in 1967, while business saving rose by 26 percent. The growth of gross saving and the drop in investment engendered a supply surplus among the concerns sampled, whereas in 1966 they had a demand surplus (a similar picture is obtained from the indirect estimate of the sector's demand surplus, as calculated in Table XVI–2). A classification of the companies shows that the reduction of the 1967 demand surplus was common to all branches.

Changes in the supply surplus of the household sector stem, by definition, from changes in its gross saving and gross investment in real assets (mainly housing). Purchases of homes were apparently on a larger scale in 1968, and this kept the sector's supply surplus from mounting. This behavior also found expression in the continued strong demand for financial assets of different types.[2]

This preference for saving in the form of financial assets and the comparatively high level of gross saving in 1968 continued the trend which began in early 1967, but with one difference: 1968 saw an increase in home purchases, whereas in the previous year there had been a decline. This change was, of course, reflected in the supply surplus: in 1967 the surplus had risen rapidly, while in 1968 it more or less tapered off.

The public sector was a source of demand pressure in 1968, accentuating the expansionary influence of the increased private sector demand. The public sector's demand surplus, which had expanded at an unprecedented rate in 1967, continued upward in 1968 despite the change in the trend of economic development.[3]

The rise in the public sector's demand surplus in 1967 can be ascribed to the much heavier defense spending, which was covered by deficit financing and contributed to the growth of economic activity. These expansionary influences helped to counter the deflationary influences emanating from the private sector, and permitted a slight growth in the annual level of GNP, after a decline in activity in the first half of the year. (For a detailed analysis of the sector's demand surplus, see Chapter VII, "Government and Non-Government Public Sector".)

The demand surplus of public sector companies, which had fallen in 1967, rose conspicuously in the year reviewed. These fluctuations are largely explained by

1 Although the sample findings are not necessarily representative of developments in the sector as a whole, they lend support to the assumption about the relative degree of changes in gross saving and investment (see Table XVI–1 in the appendix).

2 See Chapter IV, "Private Consumption and Saving", section 2, and Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 2.

3 A further means whereby the public sector regulates domestic demand is its control of investment activity by the public sector companies. In 1967 and 1968 changes in the companies' investments sharpened the fluctuations in private sector demand.

changes in the sector's gross investment, which soared approximately 90 percent in 1968 after declining the year before.

Adding the capital-account purchases of the public sector to those of public sector companies reveals sharp fluctuations in 1967 and 1968. In 1967 there was a drop of IL 175 million, accentuating the decline in domestic capital formation due to the contraction of private sector investment. In 1968 there was a rise of some IL 380 million, strengthening the sharp upswing in domestic capital formation.

The much larger capital spending by public sector companies can be attributed partly to the establishment of two new companies (an oil pipeline and the chemical complex at Arad) and partly to the larger investment in existing enterprises. In the latter category, there was a noteworthy increase in housing (following a steep decline in 1967) and in transportation companies.

The demand surplus of nonprofit institutions fell slightly in 1968, continuing the trend of the previous year. Net purchases were up somewhat in 1968, but transfers from the public sector rose to about the same extent. There was a similar development in 1967.[1]

A recapitulation of the changes in the demand and supply surpluses of the real domestic sectors in 1967–68 may help to shed light on the process of economic recovery since the middle of 1967. It was the public sector's large demand surplus in 1967 that set the wheels of the economy turning again. The growth of public sector demand also stimulated activity in the private sector. The first component of private sector demand to rise strongly was the acquisition of durable goods and household consumption; there was also an increase in purchases of homes.

The upturn in activity in the middle of 1967 apparently did not leave its mark on business investment until the end of the year, owing to the inevitable lag in responding to a change in the economic situation (see Table V–2 in Chapter V, "Domestic Investment").

With the continued upswing in economic activity in 1968 and the brighter outlook, business investment was stepped up appreciably, driving up aggregate domestic demand still further. In addition, private consumption continued to expand rapidly; this too was connected with the rise in income and the more optimistic mood prevailing, and in part it compensated for the curtailment of consumption during the recession.

Yet another factor increasing private demand was the relatively easy financing terms. The improvement in financing terms for dwelling and nondwelling investment actually began in 1967, but it was incapable of countering the effect of the slackened investment demand due to the uncertain, generally pessimistic atmos-

[1] For a detailed description of the development of the nonprofit institutions' supply surplus, see Chapter VIII, "Nonprofit Institutions".

phere then reigning. In 1968, however, the easier financing terms helped to stimulate investment on the part of both businesses and households.[1]

Although the stronger demand of the private and public sectors (including public sector companies) led to the very rapid expansion of the national product in 1968 and to the contraction of unemployment, it was not accompanied by a rise in prices. Stability was maintained in 1968 owing to the existence of idle factors of production and a much larger import surplus (represented in the flow-of-funds accounts as an increase in the supply surplus of the rest-of-the-world sector), coupled with the large supply surplus of the household sector (which was expressed in a further, but slower, growth of demand for financial assets).[2]

4. Financing the Demand Surpluses

Economic developments in 1968 led to a marked change in the financing of the demand surpluses of the major real sectors (see Table XVI–3). The year reviewed was characterized by the need to finance the larger demand surplus of the public sector and its companies, the turning of the business sector's 1967 supply surplus into a demand surplus, and the stabilizing of the household sector supply surplus.

These changes brought down the ratio between the supply surplus of the private sector and the demand surplus of the public sector and its companies from about 40 percent in 1967 to only some 15 percent in 1968. This in turn was reflected by a rise in the supply surplus of the rest-of-the-world sector (the economy's import surplus) and a change in the credit flows within the economy.

The decline in the private sector supply surplus in 1968 was a resultant of the virtual standstill in the households' supply surplus and the generation of a business sector demand surplus. The pattern of sectoral surpluses apparently returned to that existing before the recession, i.e. households ran a supply surplus, while business, the public sector, public sector companies, and the nonprofit institutions had a demand surplus. The foreign sector's supply surplus rose steeply in 1968, and this, together with the stability of the households' supply surplus, permitted the other real sectors to expand their own demand surpluses.

It should be stressed that the foregoing refers to the indirect financing of supply surpluses, i.e. the release of resources by supply-surplus sectors for the use

[1] The improved financing terms can be only partly attributed to institutional decisions (the cheapening of medium- and long-term credits granted by financial institutions for dwelling and nondwelling investment) designed to spur investment. The reduced cost of short-term financing (bill brokerage) in 1967 and up to the last quarter of 1968 was an outcome of the economic forces characterizing the recessionary period—a larger offer of funds and a smaller demand for credit.

[2] See Chapter VI, "Prices", section 2, and Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 2.

Table XVI-3

FINANCING OF DEMAND SURPLUSES, BY SECTOR, 1966–68[a]

(IL million)

	From rest of world		Net credit from domestic sectors			Total net credit received or granted (–) (2+5)	Errors and omis-sions	Demand or supply (–) surplus[c] (1+6+7)
	Trans-fers	Net credit[b]	Finan-cial sec-tors[b]	Real sec-tors[b]	Total			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Business and households								
1966	577	–85	–288	–31	–319	–404	–102	71
1967	595	–349	–1,051	100	–951	–1,300	–79	–784
1968	753	134	–1,059	–9	–1,068	–934	–71	–252
Public sector								
1966	183	492	466	–225	241	733	–6	910
1967	840	713	853	–261	592	1,305	11	2,156
1968	580	685	1,255	–230	1,025	1,710	—	2,290
Public sector companies								
1966	—	–66	46	219	265	199	—	199
1967	—	–86	41	120	161	75	–2	73
1968	—	38	8	223	231	269	—	269
Nonprofit institutions								
1966	146	—	36	37	73	73	2	221
1967	159	—	12	40	52	52	1	212
1968	154	—	32	16	48	48	–1	201
Social insurance funds and insurance companies								
1966	—	–4	–219	209	–10	–14	–13	–27
1967	—	–4	–222	216	–6	–10	–1	–11
1968	—	—	–268	263	–5	–5	—	–5
Banking system								
1966	—	70	21	–100	–79	–9	3	–6
1967	—	–221	8	175	183	–38	36	–2
1968	—	195	–94	–110	–204	–9	–28	–37

Table XVI-3

FINANCING OF DEMAND SURPLUSES, BY SECTOR, 1966–68[a] (continued)
(IL million)

	From rest of world		Net credit from domestic sectors			Total net credit received or granted (–) (2+5)	Errors and omissions	Demand or supply (–) surplus[c] (1+6+7)
	Transfers	Net credit[b]	Financial sectors[b]	Real sectors[b]	Total			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Financial institutions								
1966	—	133	198	–369	–171	–38	29	–9
1967	—	24	214	–246	–32	–8	–10	–18
1968	—	–12	362	–390	–28	–40	9	–31
Rest of the world								
1966	–906	—	–198	–342	–540	–540	87	–1,359
1967	–1,594	—	200	–277	–77	–77	45	–1,626
1968	–1,487	—	–184	–856	–1,040	–1,040	92	–2,435

[a] The figures for 1967 have been revised.
[b] From Table XVI–4.
[c] From Table XVI–1.

of sectors with a demand surplus. There need not necessarily be a similar situation in the direct financing relationships (the granting and receipt of different types of credit by the various sectors). Thus, for example, households finance the public sector's demand surplus directly, through the purchase of Government bonds, and indirectly by acquiring claims on social insurance funds; the latter activity reflects the refraining from consumption and investment in housing, which in the final analysis enables the public sector to maintain a demand surplus.

The year reviewed witnessed no striking change in the pattern of financing because of the comparatively large supply surplus (compared with 1965 and 1966) of the household sector. From Table XVI–2 in the appendix it will be seen that households remained a net lender to the rest of the economy in 1968 and even increased its credit outflow somewhat, this finding expression in the flow-of-funds system in an increased purchase of different types of financial assets.[1] There was a drop in the net amount of credit provided to the public sector and a big increase in that to the banking system. These changes were

[1] It should be recalled that, owing to the lack of data, it is not possible to estimate the flow of credit between the household and business sectors. See the discussion in section 5 below.

connected with the discontinuation of Absorption Loan collections in April 1968 and sagging sales of the Defense Loan on the one hand, and the considerably larger volume of less liquid deposits with banking institutions on the other.[1]

The formation of the business sector's demand surplus in 1968 was accompanied by the receipt of considerable net credit from the domestic financial sectors, whereas in 1967 it had been a net lender (repayment of credits and an increase in deposits).

The net credit flow between businesses and the public sector likewise showed a change of direction in 1968, after the public sector had in the previous year extended considerable credit to businesses under its policy of encouraging economic activity.

The public sector's operations in 1968 did not require much more financing than in 1967, but because of the smaller volume of funds raised abroad (as compared with 1967), the sector had to borrow more heavily from the banking system.

Furthermore, there was an increase in 1968 in the public sector's borrowed receipts which exert an expansionary monetary effect. A total of IL 2,330 million was raised from abroad and from the banking system in the year reviewed, as against IL 2,100 million in 1967. The much greater reliance on inflationary sources for financing the public sector's demand surplus in 1967 mirrored the desire to inject liquidity into the economy and stimulate demand. Such financing continued upward in 1968, but at a slower pace; however, it should be borne in mind that economic conditions changed in the year reviewed.[2]

The steep rise in the demand surplus of public sector companies in 1968 was accompanied by an increase in net borrowed receipts from the public and rest-of-the-world sectors. This was in contrast to 1967, when the companies repaid considerable sums to the rest of the world. They were able to expand their purchases on capital account in 1968 by far more than their incremental net credit from the public sector (IL 273 million as against IL 22 million), thanks to the larger share of overseas financing and the growth of the companies' gross saving.

The increase in the sector's gross saving began in 1967 and gathered momentum in the year reviewed. The advance in 1967 was mainly due to the improved profitability of a number of companies. In 1968 profits continued upward in all the branches in which these companies operate, especially transportation and communications and construction. As with the business sector, this development was connected with the notable growth of demand and sales, accompanied by a comparatively slower rise in costs.

The demand surplus of the nonprofit institutions fell in 1968 to a slightly

[1] See the discussion in section 5 below.

[2] See Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 6.

greater extent than foreign transfer receipts, so that the sector had to borrow a little less from domestic sources than in the previous year. This represents a continuation of the trend discernible in 1967, and apparently reflects the efforts made by the sector to adjust the scope of its operations to the level of its income and unilateral transfers from foreign and domestic sources. There is good reason to believe that, because of the sector's noncommercial nature, it refrained from borrowing on the scale of 1965 and 1966, when its operations were at an exceptionally high level (a result of big wage hikes and a much larger investment).

The aggregate demand surplus of the economy was financed by unilateral transfers and credit from the rest of the world. The surplus grew appreciably in 1968—by about IL 800 million, compared with IL 270 million in 1967.

The strong rise in the domestic nonfinancial sectors' demand, which drove up the aggregate demand surplus, was not accompanied by a corresponding rise in capital imports; consequently, the banking system's net foreign currency balances fell, as did public sector deposits abroad.[1]

In 1967 the picture was just the opposite. To be sure, the much heavier public sector spending increased the aggregate demand surplus by IL 270 million, but an inordinately large volume of funds was mobilized abroad after the Six Day War, particularly by the public sector. The increment consisted of unilateral transfers and long- and medium-term credit, and it permitted the banking system to expand its foreign currency holdings and the public sector to greatly augment its overseas deposits.

5. Credit Flows[2]

This section fills out the picture obtained from the data on the financing of sectoral demand surpluses (or the uses of supply surpluses), by tracing the credit flows and the network of financial relationships accompanying the saving and investment of the real sectors.

Intersectoral credit flows are often bilateral. Thus the public sector borrows from households by issuing bonds and provides them with credit to purchase homes. Social insurance funds, to take another example, receive credit from business firms in the form of severance-pay reserve accumulation and grant them credit as part of their approved investments. The magnitude of the separate gross flows is of interest, but in order to clarify the relationships among the sectors, the credit outflow must be set off against the credit inflow of each pair of sectors. One sector makes funds available to another not only by granting new loans, but also by repaying outstanding loans, and this is reflected in the gross credit-flows structure.

[1] See Chapter III, "The Balance of Payments", section 5.

[2] This section presents the table of gross intersector credit flows. The corresponding table of net flows appears in Table XVI-2 in the appendix.

Table XVI–4

GROSS INTERSECTORAL CREDIT FLOWS, 1967–68[a]

(IL million)

Borrowing sector / Lending sector	Public sector	Public sector companies	Nonprofit institutions	Business	Households	Total credit to real domestic sectors	Rest of the world	Banking system	Social insurance funds and insurance companies	Financial institutions	Total credit granted
Public sector											
1967	××	306	20	399	89	814	627	422	14	200	2,077
1968	××	422	31	317	149	919	563	—	1	232	1,715
Public sector companies											
1967	28	××	—	103	103	234	133	46	—	22	435
1968	122	××	—	71	71	264	59	39	17	—	379
Nonprofit institutions											
1967	19	—	××	—	—	19	—	37	—	2	58
1968	22	—	××	—	—	22	—	42	—	21	85
Business											
1967	162	24	26	××	[b]	212	652	197	27	24	1,112
1968	337	33	4	××	[b]	374	311	239	44	15	983
Households											
1967	344	24	13	[b]	××	381	37[c]	574	378	67	1,437
1968	208	32	3	[b]	××	243	44[c]	999	439	61	1,786

Rest of the world											
1967	1,340	47	—	339	[b]	1,726	× ×	187	—	35	1,948
1968	1,248	97	—	488	[b]	1,833	× ×	385	—	—	2,218
Banking system											
1967	966	34	24	77	—	1,101	408	× ×	1	140	1,650
1968	1,064	12	45	308	—	1,429	190	× ×	—	263	1,882
Social insurance funds and insurance companies											
1967	137	38	10	18	—	203	4	43	× ×	189	439
1968	127	27	7	46	31	238	—	87	× ×	187	512
Financial institutions											
1967	386	37	17	61	60	561	11	106	9	× ×	687
1968	297	25	43	232	122	719	12	82	6	× ×	819
Total credit granted											
1967	3,382	510	110	997	252	5,251	1,872	1,612	429	679	9,843
1968	3,425	648	133	1,462	373	6,041	1,179	1,873	507	779	10,379
Errors and omissions[d]											
1967	11	−2	1	−79			45	36	−1	−10	
1968	—	—	−1	−71			92	−28	—	9	

[a] The figures for 1967 have been revised.
[b] No data are available on credit flows between these sectors.
[c] Incomplete data—purchases of foreign securities.
[d] The errors and omissions in the rest-of-the-world column are identical with the net errors and omissions in the country's balance of international payments.

The credit flows (shown in Table XVI–5 and Appendix Table XVI–2) should be analyzed with caution, particularly when drawing conclusions about the private sector as a whole and its two component segments. And this because of the magnitude of the errors and omissions item in the sector's flow-of-funds statement and the residual method used for estimating part of the sector's credit flows. Following are the main developments in the credit-flows system in 1967 and 1968.

(a) *Households*

In 1968 the amount of gross credit provided by households to the other domestic sectors was 24 percent greater than in the previous year. As already pointed out, this increase reflected the further growth of demand for financial assets, which was accompanied by a rise in consumption and home purchases. During the year reviewed the sectoral allocation of the gross credit outflow of households underwent a conspicuous change.

Credit to the banking system soared from IL 570 million in 1967 to about IL 1,000 million. This shift in the financial asset portfolio is largely ascribable to two factors: On the one hand, there was a decline in the amount of gross credit supplied to the Government through the Absorption and Defense Loans, sales of which dropped considerably in 1968.[1] On the other hand, there was a mounting demand for financial assets offered by the banking system following the stabilization of their nominal and real yields.[2] This was mainly reflected by steep rises in saving scheme, Pazak, Tamam, and local-currency time deposits, as well as in Short-Term Loan sales by the Bank of Israel.[3]

In 1968 the banking system was the biggest recipient of household credit. The amount which it mobilized from this sector was more than double that obtained by the social insurance funds and insurance companies (contractual savings) and exceeded the sum received by all the nonbank sectors together.[4]

Household borrowing totalled IL 370 million in 1968, compared with IL 250 million the year before. Most of the increase was in housing loans from the public sector and financial institutions, and to a lesser extent in credit from the

[1] See Chapter XIX, "The Securities Market".

[2] The increase in holdings of these assets in 1968 was accompanied by a relatively small decline in the balance of bill brokerage credit (by IL 96 million as contrasted with IL 287 million in 1967).

[3] Short-Term Loan sales to the public are treated in the flow-of-funds accounts as the absorption of funds by the Bank of Israel, even though the Loan is a Government liability. The reason for this is that since November 1966 this Loan has served the Bank of Israel as an instrument of its monetary policy and not for the raising of funds by the Treasury.

[4] It should be borne in mind that an increase in currency and demand deposit holdings is treated in flow-of-funds accounting as a credit flow from the sector holding these assets to the banking system. Such an increase should not be interpreted as a regular grant of credit because of the passive role played by the lender in such cases.

social insurance funds—this too intended for the most part to finance home purchases and the acquisition of durable goods.

As already noted, no data are available on the changes in the flow of credit from businesses to households. However, it is reasonable to presume that the much heavier purchases of durable goods and housing in 1968 were accompanied by the receipt of a considerable amount of customers' credit from the business sector.[1] A further implication of this assumption relates to the data in Table XVI–2. If our assumption is correct, then the surpluses of businesses and households developed differently in 1968—the household supply surplus increased at a lower rate than shown in the table, and so too the demand surplus of the business sector.

(b) *Business enterprises*

Gross borrowed receipts of the business sector rose considerably during 1968 as a result of the rapid upswing in business activity. The total amount obtained from the three domestic financial sectors came to IL 596 million, as against IL 156 million the year before. Public sector credit fell precipitately from its 1967 level, mainly because it was no longer necessary to inject such a large sum into the business sector in order to enable some of the firms to overcome liquidity difficulties caused by the recession.

The heavier borrowing from the banking system and the financial institutions reflects the much greater demand for credit in the wake of the intensification of economic activity and investment, which was accompanied by the availability of comparatively abundant credit[2] on easy terms.[3]

Table XVI–4 shows the increase that took place in the gross credit flow from the rest-of-the-world sector to businesses in 1968 and the decline in debt repayment and in credit granted by businesses to the rest of the world. The orders of magnitude of the flows presented in Table XVI–4 are apparently biased, inasmuch as they are residual estimates. Nevertheless, it is reasonable to assume that they correctly indicate the trend in 1968—a slightly larger net credit flow from the rest-of-the-world sector to businesses, due to the higher level of activity in the economy and the brighter business picture.

There was also an increase in the volume of gross credit extended by businesses to several other sectors, in particular the public sector. Most of the growth was in

[1] On the other hand, there may also have been a flow in the reverse direction, namely, down payments on homes by households to contractors.

[2] The substitution of ordinary bank credit for bill brokerage continued in 1968, but on a smaller scale. This substitution was one manifestation of the comparatively plentiful supply of credit available throughout most of 1968.

[3] As mentioned in section 3 above, part of the incremental demand for various forms of credit can be attributed to the much easier terms offered. This is discussed in Chapter XVII, "Financial Institutions", section 2, and Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 6(c).

short-term and suppliers' credit to the public sector, which was partly offset by a decline in long-term credit, mainly purchases of the Absorption and Defense Loans. Consumer credit to households evidently rose, as already pointed out, but no data are available on this.

The incremental credit supplied to the banking system, as recorded in the flow-of-funds accounts, consisted mainly of local-currency time deposits (this is discussed in section 3 above) and currency and demand deposit holdings.

In addition, businesses may have provided credit to the banking institutions in 1968 through the bill brokerage market. This supposition is based on the big rise that occurred in time deposits of business firms in 1968 and the fact that bill brokerage is a close substitute for time deposits. Because of the lack of data, it is impossible to estimate the size of this flow.

(c) *Public sector*

Gross credit received by the public sector from the rest of the world was (like unilateral transfers) far below the record level of the previous year, when unusually large sums were raised abroad after the Six Day War. The decline in long- and medium-term borrowing in 1968 was accompanied by a marked rise in short-term credit, the resultant of a decrease in Treasury deposits abroad and an increase in ordinary short-term credit. Thus, while the net inflow from the rest of the world was only slightly below the 1967 level, the change in its composition was such as to render it less favorable from the balance of payments aspect.

Net credit from the banking system totalled IL 1,064 million, as against IL 544 million in 1967. The increment consisted of a drop of IL 534 million in public sector deposits with the banking system and an increase of IL 531 million in borrowed receipts.

It was the financing received by the public sector from overseas sources and the banking system that was responsible for most of the monetary expansion in 1968.[1]

The net credit outflow from the public sector to the domestic nonfinancial sectors went up from IL 7 million in 1967 to IL 39 million. This increase was accompanied by a drastic structural change, which rendered the public sector's credit operations more important in expanding domestic demand than would appear from the data on net credit flows. Table VII–3 in Chapter VII shows that the net outflow of long-term credit (loans granted and repaid, less loans

[1] The distinction between the role played by the rest-of-the-world sector and the banking system in the inflationary financing of 1967 and 1968 is not clear-cut owing to the marked growth in 1967 of Treasury deposits abroad and their partial withdrawal in 1968 (see Bank of Israel, *Annual Report 1967,* pp. 450–51). Since the expansionary effect of bank credit is identical with that of the conversion of foreign currency receipts, there is no point in differentiating between these two sources of credit when examining the expansionary influence of the financing of the public sector's demand surplus.

received and collections on loans granted) rose strongly—IL 306 million in 1968 as against IL 2 million the year before. On the other hand, the public sector received IL 267 million in short-term credit in 1968, as compared with an outflow of IL 5 million in the previous year. It is reasonable to assume that the expansionary effect of the incremental long-term credit granted in 1968 was only partly offset by the contractionary effect of the incremental short-term credit received.

It therefore follows that while there was no conspicuous change in the public sector's net credit outflow in 1968, its financial intermediation had a greater expansionary effect on demand than in 1967.

(d) *Public sector companies*

In 1968 the public sector companies received a larger amount of gross and net credit from the public sector than in the previous year. They were also the recipients of net credit from the rest of the world; this contrasts with the situation in the previous year, when the net flow had been in the opposite direction owing to the repayment of debts. The role played by the domestic financial sectors in financing the public sector companies remained very slight—they provided a total of IL 8 million in 1968 compared with IL 41 million in 1967.

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

This sector provided more gross and net credit to the real domestic sectors in the year reviewed, while the depletion of the economy's foreign exchange reserves suggests an additional flow of credit to the financial sectors. In 1967, on the other hand, the banking system and the public sector accumulated foreign currency on a large scale, which in flow-of-funds accounting is regarded as the granting of credit to the rest of the world.

The flow of Israeli currency to the administered territories appears in the credit-flows table as the granting of short-term credit by the rest-of-the-world sector to the banking system. According to the country's baalnce of international payments, this amounted to IL 93 million in 1967 and IL 16 million in 1968.[1]

(f) *The banking system*

In 1968 the banking system extended much more gross and net credit to the public and business sectors, the principal recipients among the nonfinancial sectors of bank credit. (The reasons for this increase were dealt with at length in Chapter XV, "Money Supply, Credit, and the Banking Institutions", section 6.) The year reviewed saw a steep rise in gross credit from banking to financial institutions, with most of the increase being in loans to bank subsidiaries operating as financial institutions.

[1] Estimates based on monetary data suggest that the 1968 data are biased downward, and that the flow was of the order of IL 30–50 million.

(g) *Social insurance funds and insurance companies*

The allocation of credit granted by the social insurance funds and insurance companies was similar to that in 1967. There was a slight decline in the amount going to the public sector and public sector companies, while that to the financial institutions held steady and banking institutions were the recipients of a larger sum. In 1967, on the other hand, the share of credit directed to the public sector rose steeply, in response to its increased finance requirements and the diminished demand of the other nonfinancial sectors.

(h) *Financial institutions*

The major sources of credit for this sector continued to be the social insurance funds and insurance companies and the banking institutions. The large sums flowing through the financial institutions in the form of credits from earmarked public sector deposits are treated, as already mentioned, as credit granted directly by the Government to the final borrowers.

In 1968 financial institution lending was on a much greater scale than in the previous year, owing to the appreciable expansion of private investment and demand for finance. The incremental credit provided to the private sector far exceeded the incremental borrowed receipts of the financial institutions, so that they had to reduce their lending to the public sector.