

CHAPTER XVI

MAIN DEVELOPMENTS IN THE MONEY AND CAPITAL MARKETS

Developments in the money and capital markets and measures taken in those markets must be examined and evaluated according to the extent of their contribution to achieving the goals of the economic policy. These goals pertain to the aggregate demand level and its composition, to price levels, and to the balance of payments, and their achievement is primarily a matter of budgetary policy measures and rate of exchange policy. Monetary and capital market policies play an important, though limited, role by supplementing budgetary and exchange rate measures.

As indicated in previous chapters, the policy of the public sector in 1976 was intended to achieve a rapid reduction of the deficit in the current account of the balance of payments. This was to be accomplished by vigorous export promotion and by restraining the demand of domestic uses (consumption and investments), while maintaining a moderate level of economic activity without substantially increasing unemployment. Besides reduction of public expenditures, the measures taken for restraining domestic uses were mainly fiscal. In addition the creeping devaluation was introduced to encourage export. The fiscal measures (indirect taxes, reduction of subsidies) and the creeping devaluation, as well as the effect of institutional arrangements in the field of wages, led to a rapid rise in prices.

This situation requires a careful monetary policy. On the one hand, this policy had to be restrained enough to prevent the monetary developments from turning the price rise created by economic policy into an inflation of demand. On the other hand, the monetary restraint could not be allowed to slow economic activity below planned levels. This could occur if monetary expansion were not rapid enough to allow financing of most of the growth in the cost of policy measures and wage agreements. A further objective of the monetary policy was to maintain the level of domestic interest rates so as to prevent the use of domestic credit for speculation in foreign currency since the rise in the return on foreign currency assets following the introduction of the creeping devaluation¹.

On the other hand, the capital market required a complementary policy that would restrain domestic uses. A slowdown of economic activity and a heavier tax load mean a decrease in real disposable income. This is naturally accompanied by lower savings, and

¹ It should be noted that there exists a ceiling for domestic rates of interest above which it becomes more worthwhile to receive credit from abroad, which creates a danger of flooding the economy by liquidity.

TABLE XVI-1

SELECTED INDICATORS OF THE MONEY MARKET, 1975 AND 1976

	1975		1976			
	Increase or (-) decrease		Increase or (-) decrease			
	During the year	Annual average	During the year	Annual average		
	(IL million)	(percent)	(IL million)	(percent)		
Changes in broad money base and in liquidity deficiencies	1,958	24	30	2,250	22	14
Change in narrow money base	335	5	26	3,325	46	18
Injection from the public sector	5,460	—	—	8,142	—	—
Absorption through payment balance of private sector	-5,083	—	—	-4,349 ^a	—	—
Outstanding balances at the end of the period						
Means of payment	10,614	22	31	13,486	27	18
Free credit	7,072	30	20	8,958 ^b	24 ^b	29 ^b
Directed credit	7,951	41	70	11,119	40	36
Thereof: for export	(5,828)	(27)	(73)	(8,542)	(47)	(45)
Total of free and directed credit	15,023	36	38	20,077 ^b	32 ^b	33 ^b

^a Excluding the transfer of export shipments financing to credit lines of banks abroad – IL 5,749 million.

^b In September 1976 credit to the local authorities totaling IL 220 million was transferred from the framework of credit to the government to the framework of free credit in foreign currency to the public. This credit is included in the annual data, but not in the calculation of the rate of growth.

even a temporary drop in the rate of saving. Therefore, a policy that encourages saving was required in order to restrain private consumption, as well as a selective investment financing policy which would not prevent the decline of investments both in the economic sectors and in housing. Such a decrease was dictated by the continuing standstill in economic activity and the curtailment of direct and indirect investments of the public sector.

In general terms, the rapid monetary development during 1976 did not intensify the pressure on the aggregate demand level and the rate of price rises, despite the relatively large growth in potential monetary development during the year. This was largely due to the restraint measures taken especially in the areas of free credit and interest rates. In addition, there was a policy of directing credit which gave substantial preference to financing of exports over financing of production for the domestic market.

In contrast the policy measures taken in the capital market partly neutralized the restraining influence of the standstill in economic activity and governmental budgetary policy on domestic uses. In savings: towards the end of 1975 the terms of index-linked savings worsened, against a background of decreasing return on almost all savings (foreign currency, housing, etc.). This certainly has a negative effect on the household propensity to save. In investment financing there was considerable growth both of investment financing (directed and subsidized) in the various economic sectors, and of acquisition of dwellings relative to the investments (and house buying) which have taken place. This growth was instrumental in halting part of the downward trend in investments caused by the prolonged standstill in economic activity. This marked increase in the rate of financing was perhaps intended to prevent too steep a decrease in investments and was therefore consistent with the objectives of the economic policy (a controlled decline in economic activity and in the level of investments). However, with respect to savings the situation was different, the worsened terms of savings neutralized the restraint on private consumption to a great extent. This restraint, accomplished by increased taxation, was achieved at a high price — a more rapid rate of price rises having negative effects on the wage front and on the budgetary burden (connected with the asymmetric linkage policy of the government).

Monetary expansion was relatively restrained in 1976, a fact which contributed to the maintenance of a moderate rate of economic activity. At first glance it would seem, however, that the two central monetary aggregates — the money supply and bank credit (free and directed) — indicated contradictory influences. Bank credit (free and directed) increased at an average annual rate of 33 percent, similar to the rate of price increase of the basket of uses, which does not indicate a monetary restraint.

On the other hand, the increase in money supply (at an annual average rate of 18 percent) lagged far behind prices and gives the impression of a strong deflationary influence on economic activity. In fact, the decrease in the real balances of the money supply resulted mainly from a further adaptation of the public's demand for money supply to

TABLE XVI-2

SELECTED INDICATORS OF THE CAPITAL MARKET, 1975 AND 1976

	Increase or (-) decrease from previous year			
	1975		1976	
	(IL million)	(percent)	(IL million)	(percent)
Main components of household savings through the Institutional System of the Capital Market				
Social insurance funds	1,740	15	2,160	25
Saving schemes	2,190	29	2,460	12
Mutual funds	1,870	87	1,820	-3
Life insurance	450	41	620	38
Net dealings in securities	-650	-	-780	-
Total of financial savings	5,600	42	6,280	12
Net issue of government bonds	1,013		-600	
Gross medium- and long-term credit through the Institutional System of the Capital Market				
Mortgage credit to households	1,830	26	2,110	15
Credit to industry	1,650	76	2,380	44
Credit to agriculture	630	29	850	35
Other credit	2,680	46	2,990	12
Total of all medium- and long-term credit	6,790	-	8,330	-

changes in the liquidity of various money substitutes (and their volume) following the rapid price rises and the introduction of the creeping devaluation. All those factors caused an irregular downward trend in the demand for money during the last 2 years, whose extent it is difficult to determine. On the other hand, the increase in bank credit (at a rate similar to the rate of price rises) was relatively restrained, even taking into account the fact that other financial institutions (such as insurance companies) extended quite substantially the short-term credit that they granted, and that limited use was made of long-term linked credit for financing current activity.

The main reasons for this were:

- a) Lower sales (to the domestic market) and smaller profit margins which accompanied the standstill in the level of economic activity caused credit requirements to grow more than the amount dictated by the expenses resulting from the policy measures. To this must be added a more intensive tax collection due to payment of arrears and the effect of inflation on capital gains from inventories.
- b) The government's policy to restrict budgetary expenditures during April-July and August-November 1976 to 1/15 and 1/12 of the budget respectively. This policy, even though it was partially successful, restraining the real demand of the government during this period, almost certainly expressed itself as well in the arrears in the payments of the public sector to its suppliers, and this naturally increased the latter's need for credit.

This year, as in the past, no monetary restraint was imposed on directed credit for the financing of exports. On the contrary, this credit rose at an average annual rate of 45 percent in order to keep up with the considerable expansion of export activities in 1976.

However, the Bank of Israel did consider the need to raise the interest rate on this credit in order to lower the element of subsidy in it. This subsidy grew substantially in recent years due to the accelerated rate of inflation, and this encouraged excessive use of credit, even though there is no close correspondence between the amount of credit granted (and the subsidy element in it) and the value added to the exports financed by it.

The monetary policy measures taken during the year did achieve a relatively restrained monetary expansion, in spite of the growth in the potential of monetary expansion (as reflected in the growth rate of the money base).

The substantial growth of the (narrow) money base (approximately 46 percent)² was the result of two main processes:

² The relevant definition of the money base, which indicates the effect of net external infusion on the rate of monetary expansion is the broad money base (including exemption from liquidity, recognized difference, etc.) plus the changes in liquidity deficiencies. According to this definition, the increase in the money base amounted to 22 percent in 1976.

- a) The great increase in the liquidity injection of the public sector to the economy, due both to a budgetary deficit and to the conversion of foreign currency by the government and the Jewish Agency for financing their activities in the domestic market.
- b) Halting the growth of absorption through foreign currency sales to the private sector. The drop in absorption was rather moderate, as the substantial drop in the deficit in the current account of the private sector was accompanied by lessened need for short-term credit from abroad by this sector. The decrease in absorption was smaller in terms of Israeli currency than in foreign currency terms due to the increase in the rates of exchange.

The Bank of Israel took policy measures to moderate the extension of free credit and raise its cost. It also caused part of the growth in the money base to be directed towards the diminishing of liquidity deficiencies suffered by the banking system. These steps partly neutralized the widening monetary influence of the growth on the money base. It should be noted that the increase in the rates of debit interest also helped to prevent the use of this credit for financing speculation in foreign currency. The major step taken by the Bank of Israel was a special loan arrangement of IL 400 million granted to the banking system. This loan was granted under restrictions concerning the rate of free credit growth. For banks suffering deficits, this arrangement raised the cost of extending credit above the given limitation (see Ch. XVII). This arrangement enables the Bank of Israel to have direct influence on the rates of debit interest (they rose by 8 percent in 1976) by means of raising the marginal cost of extending credit. However, this measure can not serve as a major policy tool in the long run. First of all, its efficiency depends on the banks suffering liquidity deficiencies³. Secondly, there is a danger that such an arrangement will gradually divert the money market from the banking system. Furthermore, when the cost of acquiring a deficit exceeds the cost of the linked sources in the capital market, the banks are encouraged to use those linked sources for financing bank credit activity. The entire banking system might be adversely affected by such a development.

In order to illustrate the strength of the policy that restrained free credit during 1976 we shall note that during the year credit increased by only 24 percent as against an increase of 34 percent in prices for domestic uses and 38 percent in the Consumer Price Index⁴. Approximately half the increase in free credit during 1976 occurred in the first quarter of the year (prior to the introduction of the IL 400 million loan arrangement), whereas during the following three quarters of the year free credit increased by only 11 percent.

To sum up the developments in the money market in 1976 one should note with concern the increase in injection of liquidity to the market during the last months of 1976

³ With the disappearance of liquidity deficiencies in the first months of 1977, it was decided to phase out this arrangement.

⁴ Comparing the last quarter of 1976 with the last quarter of 1975.

and the first quarter of 1977, which was accompanied by a considerable growth in the money supply of the public.

It seems that the growth of the real balance of the money supply was not linked to the changes in the demand level and economic activity. It derived from an increase in the liquidity preference of the public as the profitability of investing in bonds was in doubt, and a slowdown in the rate of inflation, during the period until the elections, was expected. There is a danger, however, that expectations will change in the near future (previous experience shows that these expectations are subject to frequent changes), and stronger injection of liquidity into the economy will follow. In order to cope effectively with the monetary problems which will be facing the economy, certain changes must be made in the instruments of monetary policy, to increase their efficiency.

In the capital market in 1976, as observed from the activity of the Institutional System of the Capital Market (and the securities market), there was a substantial reduction of financial sources mobilized (which was a direct result of the decrease in savings of the private sector). To a lesser extent there was also a reduction in the uses of those sources (these uses are mainly long-term subsidized financing of investments in the economic sectors and of acquisition of durable items especially housing). However, there was a surplus of sources over uses (for long and medium terms). This surplus was only partially absorbed this year by the government (approximately IL 910 million)⁵ as it subsidizes both sources and uses.

Part of the surplus (about one billion IL) was transferred to the banking system for financing its independent activity in granting credit (see Table XVIII-1), though not through conventional deposits which require liquidity.

The considerable reduction in financial sources directed to the Institutional System of the Capital Market was linked to the decline of household savings (an outcome of the fall in real disposable income). The reduction of savings essentially encompassed all kinds of household savings in all its forms. The decrease was sharpest in relatively liquid financial saving (direct holding of bonds and participation certificates of mutual funds; see Table XVII-3).

The decrease in real disposable income (about 4 percent) caused mainly by the heavier levy of taxes imposed by the government was supposed to lower the rate of savings. However, it is a fair assumption that the steep decrease in the rate of savings in 1976 (about 24 percent) was contributed to, not insubstantially, by the worsening of financial saving terms towards the end of 1975 and the fear of the public that the linkage terms of existing bonds would also be affected)⁶. To this we should add the indirect

⁵ Compared with IL 1,660 million in 1975.

⁶ These fears grew stronger in the second half of 1975 and constituted part of the reason for the decrease in household savings during that period (see Annual Report 1975, Chapter XVII). They have not ceased in spite of firm denials of the authorities concerned.

negative influence on the current savings of households of substantial real capital gains of households holding "old" bonds, as a result of the worsening of terms of issue (see Chapter XIX).

To sum up – the worsening of index-linked saving terms followed by lower rates of return on other kinds of savings (housing, foreign currency, etc.) caused an increase of private consumption. Thus part of the restraint achieved by fiscal means was neutralized, and this at the heavy cost of acceleration in the rate of price increases.

The data relating to net issues of bonds – which is a good indicator of the total index-linked savings of the public – indicate a most severe situation; 1976 saw a decline of 55 percent in net issues, after a decline of approximately 16 percent in each of the years 1975 and 1974. They were comparable to the real level of net issues in 1971⁷.

It can be assumed that the further worsening of the terms of index-linked savings at the end of 1976, which also seriously hurt institutional medium- and long-term savings this time (for details see Chapter XIX), will have a considerable influence on the future development of household savings. Neutralizing this negative influence on the aggregate demand level means heavier taxes or greater cuts in public-sector expenditure.

The development of medium- and long-term uses in the institutional system of the capital market shows that the policy adopted by the public sector for financing investments and acquisition of housing was basically expansive. This policy could offset part of the restraint on investments imposed by the public sector, as expressed in budgetary expenditures. This financing, which is mainly subsidized, and granted either directly or indirectly by the public sector, increased this year over and above the growth rates in the value of the financed investments. In other words, this year the rate (or timing) of the subsidized financing of investments increased considerably. This is especially true of investments in industry (a growth of 30 percent in the rate of investment financing) and the purchase of homes by households. This increase occurred even though the formal criteria for granting subsidized credit did not change. Changes in these criteria at the beginning of 1976 concerned rates of interest only which were raised by several percent (for details see Chapter XVIII). Increase in interest rates in other economic sectors will become effective only for investments carried out in 1977, since most of the financing granted in 1976 was based on approvals given prior to the increase of interest rates.

The discussion on the money and capital markets cannot be concluded without criticizing the lack of coordination between the government's policy in the capital market and the needs of the monetary policy.

⁷ The real decline in the index-linked saving of households was steeper than that seen in the data of the institutional system of the capital market (15 percent) since these do not include household savings by purchase of government bonds. The net issue of those bonds, mostly acquired by households, amounted to IL one billion in 1975, and changed to net redemption of IL 0.6 billion in 1976.

The root of the problem lies in the fact that the Israeli capital market, which is actually controlled by the government, lacks a link between the volume of savings and the return on them on the one hand, and the volume of uses and their price on the other. Furthermore, the public sector has great difficulty in controlling at every moment the entire volume of sources which it subsidizes. Due to the extensive involvement of the banking system in the capital market, it was possible to transfer a wide range of financial sources (whose extent it was difficult to anticipate) to the financing of credit granted by the banks, without having the accepted liquidity rates of the monetary policy apply to these sources⁸.

In a situation such as ours this is extremely severe, when the marginal cost of sources in the money market (the effective penalty on liquidity deficits) is higher than the cost of the linked sources in the capital market.

⁸ Certain policy measures also helped; for example, the worsening of terms of saving at the end of 1975 improved the relative attraction of saving programs. Part of the accumulation of these programs is not subject to the conventional rates of liquidity.