

CHAPTER VIII

MONEY AND CAPITAL MARKETS

In 1983 the economy was dominated by the exceptional developments in the money and capital markets, which reached their peak in October, unsettling the capital market and doubling the rate of inflation.

The public's financial portfolio shrank by a formidable 21 percent in real terms during 1983, while the nominal increase slackened compared with the three preceding years. This was the net outcome of contrasting developments: On the one hand, the average nominal monthly growth of liquid asset holdings¹ rose from 8.5 percent in 1980–82 to 10 percent in 1983, further augmenting their real value (although more moderately than last year). On the other hand, the real value of the public's shareholdings fell drastically (about 70 percent during the year). Short-term bank credit² also declined appreciably in real terms (approximately 20 percent during the year), in accordance with the Bank of Israel's restrictive credit policy, and in nominal terms it expanded to about the same extent as in 1982 despite the acceleration of inflation. Incremental new medium- and long-term credit (part of which is granted by the government) declined 12 percent in real terms, after a 40 percent real increase in 1982, while the average balance of such credit (most of which is linked) swelled 36 percent in real terms, after a rapid rise in 1982 as well. The public's net financial wealth shrank 16 percent in real terms during the year, with most of the decrease taking place in the fourth quarter.

These developments can be attributed to a combination of persisting factors—a large public sector budget deficit against the background of the structure of Israel's capital market—together with special factors at work this year: the devaluation expectations engendered by the deliberate slower depreciation of the sheqel (in relation to domestic inflation) from September 1982 onward, and the deep stock market slump after an unprecedented boom in previous years.

The large public sector domestic deficit, a longstanding feature of the Israeli economy, has ex post been financed in three ways: (a) a steady increase in the government's domestic debt to the public; (b) the purchase of foreign currency by

¹ The liquid asset base constitutes a government liability and consists of the money supply, time deposits, negotiable certificates of deposit, tradable government bonds, and Patam (sheqel deposits denominated in foreign currency); it does not include bank shares.

² The Bank of Israel's credit target is short-term bank credit, excluding that for oil imports, diamonds, overseas transport, and for opening savings schemes.

Table VIII-1
INDICATORS OF MONETARY DEVELOPMENTS, 1978-83

	Average balance relative to annual GNP (%)									Percent average nominal monthly increase during the period					
	1978	1979	1980	1981	1982	1983			1980	1981	1982	1983			
						Total	I-III	IV				Total	I-III	IV	
1. Narrow monetary base ^a	7.3	4.9	3.5	2.8	2.8	2.5	2.8	2.1	5.8	6.5	5.9	8.4	6.1	15.7	
2. Unlinked liquid assets ^b	12.3	8.7	6.6	6.1	6.5	6.9	7.3	6.2	6.7	6.7	9.0	7.8	6.3	12.3	
3. Liquid assets ^c	44.4	40.7	39.1	37.6	39.3	38.5	37.0	41.2	7.9	6.3	7.1	10.1	8.0	17.8	
4. Liquid assets plus bank shares	65.2	55.5	51.2	56.4	63.2	64.6	68.2	58.2	8.7	7.4	8.3	7.3	8.3	5.1	
5. Total financial assets ^c	116.0	103.3	102.5	109.9	139.2	142.0	147.2	132.9	8.8	7.4	9.4	7.2	6.4	9.4	
6. Bank credit (excl. oil) to private nonfinancial sector ^d	28.7	30.7	26.6	22.9	20.9	18.9	19.0	18.7	6.4	5.1	7.5	7.3	5.7	12.1	
7. Medium- and long-term credit ^c	29.7	27.3	23.3	23.4	28.4	37.6	39.3	37.7	6.7	7.6	9.6	12.0	9.3	18.4	
8. Net financial wealth of private nonfinancial sector ^f	105.7	102.3	109.6	114.8	126.5	123.0	126.5	113.0	8.7	7.0	8.2	7.7	7.7	9.8	
9. Consumer price index									7.3	6.0	7.2	9.3	7.2	15.9	
10. Exchange rate (IS/\$)									6.5	6.2	6.6	10.2	7.4	19.2	

^a Source: Table VIII-A4.

^b Money (M1), time deposits, and CDs, as detailed in Table VIII-A10.

^c As detailed in Table VIII-A10.

^d As detailed in Table VIII-A21.

^e As detailed in Table VIII-A19.

^f As detailed in Table VIII-A16.

the public, which essentially increases the external debt; and (c) money creation.³ In 1982 and 1983 the deficit was narrowed compared with the two preceding years, but its magnitude and financing requirements are still enormous (see Table VIII-5). Given the structure of Israel's capital market, where the range of most financial asset yields is limited, the deficit financing mix is largely a function of the public's preferences: Whereas formerly the government financed the deficit primarily by increasing its domestic debt and to a lesser extent its external debt and only fractionally by money creation, in 1983 the devaluation expectations, and perhaps also the size of the domestic debt, led to a much greater resort to external financing, while the growth of domestic indebtedness slackened appreciably and money creation remained insignificant.

Monetary developments deviated, as stated, from their previous years' pattern because of the mounting devaluation expectations. The latter had its roots in the policy of slowing the depreciation of the official exchange rate from September 1982 onward, which failed to conduce a corresponding slowing of domestic inflation. Because of the diversion of domestic demand to imports and the growth of the external debt, the public expected the government to retreat from this policy, with a consequent accelerated depreciation of the currency or the implementation of a large one-time devaluation.⁴ The ensuing reshuffling of the public's financial portfolio took on increasing proportions, and so it too strongly influenced the expected rate and timing of the devaluation.

At the beginning of the year the stock market began to weaken, depressing nonbank share prices. Bank shares, however, did not lose ground at this stage as those thrown on the market by the public were picked up by companies affiliated with the banking groups. It was only in October, when the supporting of bank shares was discontinued, that their price responded to the slump.

The severe stock market slump and mounting devaluation expectations combined to bring on the extraordinary events in October: the plunging of the capital market into a crisis and the policy measures adopted with respect to the exchange rate and prices. These developments sharply altered the prevailing trends in the monetary aggregates and inflation, and for analytical purposes it is therefore necessary to divide the year reviewed into two periods—before and after October.

First Nine Months of 1983

The public sector and the monetary authority generate a perennial exogenous injection,⁵ which for the most part represents the large domestic budget deficit—

³ Money creation implies an increase in the sheqel monetary base (high-powered money); it is often wrongly associated with the entire deficit or the exogenous injection.

⁴ These expectations prevailed despite the experience of the last few years in Israel, which demonstrated that nominal devaluations do not lead to a real devaluation in a full-employment situation (which existed during the period reviewed) except in the very short run, and that their principal result is an increase in the inflation rate without any improvement in the balance of payments.

⁵ The exogenous injection is equal to the total contribution of the public sector and monetary

Table VIII-2
SOURCES AND DISTRIBUTION OF NOMINAL INCREASE IN LIQUIDITY GENERATED BY EXTERNAL INJECTIONS, 1980-83
 (IS billion, at current prices)

	Percent of GNP									
	1982	1983			1980	1981	1982	1983		
		Total	I-III	IV				Total	I-III	IV
1. Sources of incremental domestic liquidity										
a. External public sector injection										
(excl. purchase of bank shares)	51.9	91.8	60.1	31.7	10.6	13.6	9.6	6.7	6.9	6.4
(1) External public sector injection plus purchase of bank shares		145.9		85.8				10.7		17.4
b. External Bank of Israel injection	4.5	53.8	26.2	27.5	4.1	1.1	-0.1	4.0	3.0	5.6
c. Total external injection (a+b)	56.4	145.6	86.3	59.3	14.7	14.7	9.5	10.7	10.0	12.0
d. Leakage through balance of payments	27.2	98.1	36.4	61.7	4.3	3.3	4.1	7.2	4.2	12.5
e. Total injection (c-d)	29.2	47.5	49.9	-2.4	10.5	11.4	5.4	3.5	5.8	-0.5
(1) Incl. purchase of bank shares		101.6		51.7				7.5		10.5
2. Distribution of incremental domestic liquidity										
f. Money creation (=change in money base)	9.6	31.7	13.6	18.0	2.2	2.1	1.8	2.3	1.6	3.6
g. Addition to linked liquid asset base	-5.3	73.9	37.7	36.2	3.1	1.0	-1.0	5.4	4.4	7.3
(1) Foreign currency deposits ^a	1.0	88.8	49.2	39.6	1.9	3.0	0.2	6.5	5.7	8.0
(2) Tradable bonds	-6.3	-14.9	-11.5	-3.4	1.1	-2.0	-1.2	-1.1	-1.3	-0.7
h. Addition to medium- and long-term asset base	24.9	-3.9	-1.4	-2.5	5.2	8.3	4.6	-0.3	-0.2	-0.5
(1) Patam restitution deposits	5.2	10.3	-1.4	11.7	0.6	0.7	1.0	0.8	-0.2	2.4
(2) Savings schemes and social insurance funds ^b	19.7	-14.2	0.1	-14.3	4.6	7.6	3.7	-1.0	0.0	-2.9
i. Purchase of bank shares		-54.1		-54.1				4.0		-11.0

^a Patam and Patach deposits of Israeli residents.

^b Net long-term government borrowing from the private sector, less early redemption of State of Israel Bonds.

i.e. the excess of domestic expenditure over revenue from taxes. In the first nine months of 1983 the total exogenous injection was equal to 10 percent of GNP—similar to the 1982 figure but less than in previous years (the sources of the injection are presented in Table VIII–A5). The decline occurred despite the expansion of the government's real activity, and was due to a bigger tax collection and smaller subsidy outlay. The growth of tax revenue can be mainly credited to the imposition of new taxes in the wake of the Peace for Galilee Operation, but in part it stemmed from an endogenous increase in tax receipts arising from the larger import in the last two years of highly taxed products. The exogenous injection generated by the public sector alone does not reflect all of its budget deficit. The subsidy element in directed credit, which is given through the Bank of Israel (mostly for export purposes), is recorded as an exogenous Bank of Israel-engendered injection.⁶ During the period reviewed this injection amounted to about 1 percent of GNP, which was more than in the two preceding years.

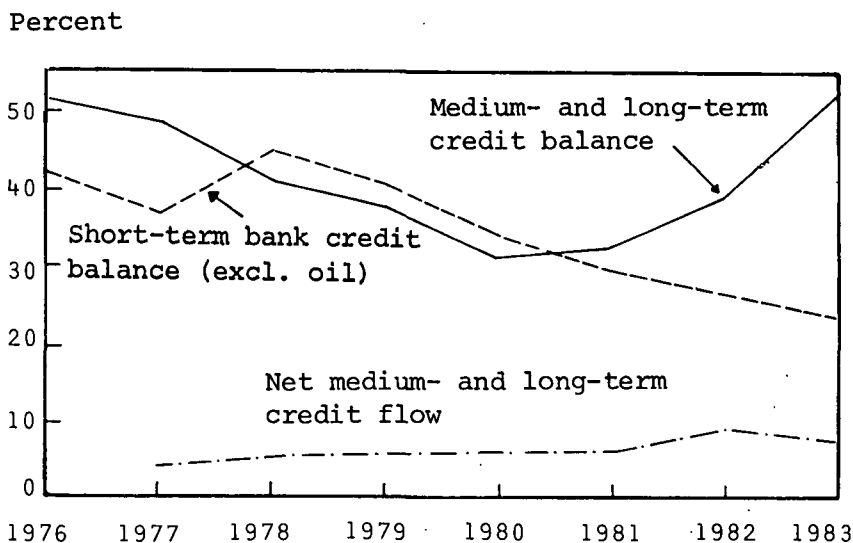
The exogenous injection during the first nine months of 1983 resulted in a continued substantial accumulation of linked assets by the public (domestic debt)—equivalent to 4 percent or more of GNP—and the purchase of foreign currency from the government on a similar scale, while money creation stayed at its low level of under 2 percent of GNP (see Table VIII–2). The devaluation expectations that arose during this period caused the public to prefer short-term assets linked to foreign currency over sheqel assets, indexed assets, shares, and other long-term assets. With the intensification of devaluation expectations another factor was added: fear of the possible imposition of more import taxes and the impairment of financial assets. This heightened the public's demand for foreign currency for portfolio purposes, along with an increased demand for consumer durables and imported investment goods. There was thus a heavier purchase of foreign currency by the private sector and a greater absorption via the balance of payments, which together curtailed the incremental domestic liquidity.⁷ Part of this reduction was offset by the large-scale import of capital, until the end of September 1983, by affiliated companies for supporting bank shares. The changed composition of the public's financial portfolio also contributed to the monetary squeeze, as it indirectly shrank the supply of domestic credit still more. This contraction, which accorded with the Bank of Israel's targets, was connected with the differential structure of the monetary policy tools, which facilitate the provision of unlinked credit from the banks' sheqel resources and restrict credit from their foreign currency-linked resources. The substantial real squeeze on the sources of domestic credit stemming from the switch to Patam was partly offset by the liquidity shortfalls incurred by the banks.

authority to the monetary expansion, which is channeled to the purchase of foreign currency, the growth of linked domestic indebtedness for short and long terms, and money creation (see Table VIII–2).

⁶ Beginning in fiscal 1984/85 this item will be included in the government budget.

⁷ The reference is to that part of the exogenous injection that remains in the economy and does not leak out via the balance of payments (see Table VIII–2).

Figure VIII-1
AVERAGE CREDIT BALANCES AND FLOWS RELATIVE TO BUSINESS
SECTOR PRODUCT, 1977-83



The Bank of Israel's policy was designed to enable the contractionary monetary forces generated by the reshuffling of the assets portfolio to restrict the volume of credit. But the incurring of liquidity deficits by the commercial banking system, together with the Bank of Israel's tendency to avoid an undesirable crowding-out of private sector activity and the excessive increase in real interest, prompted the central bank to ease the credit curbs through the combined use of liquidity ratios and discount-window lending.

The diminished supply of bank credit, the bulk of which is used for financing short-term activity, led to a real drop in its outstanding balance.⁸ During the period concerned such credit expanded nominally at a 5.7 percent average monthly rate, i.e. 1 percentage point less than the average monthly rise in prices. This was consonant with the targets set in the last few years with the intention of damping down the monetary expansion, and which led to a marked real reduction of short-term credit. Such credit as a proportion of business sector product moved steadily downward from 45 percent in 1978 to 25 percent this year (see Figure VIII-1). This drop, which was quite sharp and may seriously harm productive activity, was only partly offset by alternative types of credit—medium-term foreign currency credit and long-term credit. The resort to such finance has increased in

⁸ The reference is to credit extended by the commercial banking system to the private nonfinancial sector other than for financing oil imports. Even including such imports, the amount of credit declined.

Table VIII-3
GROWTH OF FINANCIAL ASSETS OF THE PUBLIC, 1982-83
 (IS billion)

	1983				Percent of GNP			
	1982	Total	I-III	IV	1983			
					1982	Total	I-III	IV
1. Contribution of injections and financial intermediation								
a. Total injection ^a	29.2	47.5	49.9	-2.4	5.4	3.5	5.8	-0.5
(1) Addition to liquid asset base ^b	4.3	105.5	51.3	54.2	0.8	7.7	5.9	10.8
(2) Purchase (-) of bank shares by the government	0.0	-54.1	0.0	-54.1	0.0	-4.0	0.0	-10.7
(3) Addition to medium- and long-term asset base	24.9	-3.9	-1.4	-2.5	4.6	-0.3	-0.2	-0.5
b. Expansion generated by domestic financial intermediation	27.0	-15.4	20.4	-35.8	5.0	-1.1	2.4	-7.1
c. Purchase of assets by the public ^c	56.2	32.1	70.3	-38.2	10.5	2.3	8.1	-7.7
(1) Liquid assets	9.6	45.2	38.5	6.7	1.8	3.3	4.5	1.4
(2) Shares of financial concerns ^c	9.9	-58.0	1.4	-59.4	1.9	-4.3	0.1	-12.0
(3) Medium- and long-term assets	36.7	44.9	30.4	14.5	6.8	3.3	3.5	2.9
2. Contribution of asset revaluation								
d. Total revaluation	789.6	2,183.3	1,198.5	984.8	147.1	160.6	138.4	199.4
(1) Liquid assets	146.7	599.4	235.0	324.4	27.1	41.2	27.1	65.7
(2) Shares of financial concerns	183.3	99.6	249.4	-149.8	34.2	7.3	28.8	-30.4
(3) Medium- and long-term assets	459.6	1,524.3	714.1	810.2	85.8	112.1	82.5	164.1
3. Total contribution (1c+2)								
					Percent nominal change relative to beginning-of-period balance, at monthly rates			
e. Change in asset balances ^d	845.8	2,215.4	1,268.8	946.6	8.6	8.4	7.6	10.8
(1) Liquid assets	156.3	604.6	273.5	331.1	7.1	10.1	7.9	16.9
(2) Shares of financial concerns	193.2	41.6	250.8	-209.2	11.2	1.2	7.6	-15.8
(3) Medium- and long-term assets ^d	496.3	1,569.2	744.5	824.7	8.4	9.5	7.6	15.3

^a Public sector and Bank of Israel injections, less leakage through the balance of payments (Table VIII-2, line 5).

^b Money base plus linked liquid asset base.

^c The data are upward-biased since they do not include shares sold by the public to affiliates that supported bank share prices; the sales are estimated at 4 percent of GNP.

^d As defined in Table VIII-A16, less compulsory loans and export credit.

recent years (see Figure VIII-1),⁹ although less rapidly in 1983. The marginal real interest on short-term credit rose during this period, evidence that the contraction of this type of credit was dominant, even though demand for it was subject to contrasting influences: the expansion of real and foreign currency transactions on the one hand, and a slump in stock market transactions on the other.

The combined effect of the exogenous injection, balance of payments absorption, and real decrease in bank credit was reflected by a sharp drop in purchases of domestic financial assets by the public (Table VIII-3)¹⁰—from 10 percent of GNP in each of the years 1980–82 to a much lower figure in the period reviewed.¹¹

In the inflationary conditions prevailing in the first nine months of 1983 (prices rose at a 7 percent average monthly rate, about the same as in the three preceding years), most of the financial aggregates continued to expand strongly in nominal terms. The smaller acquisition of assets during this period somewhat slowed the nominal growth of total financial assets, with a more rapid increase in liquid assets outweighed by a deceleration in medium- and long-term assets and especially bank shares. The nominal expansion stemmed largely from the automatic appreciation of the bulk of the public's assets. But it should be emphasized that the assets are not fully linked; all sheqel assets erode when there is inflation, and so too to some extent do part of the assets linked to foreign currency (Patam demand deposits).¹² The erosion of sheqel assets is largely confined to money (M1), which is held for domestic transactions purposes. The public therefore has to constantly increase its nominal money balances, despite the determined attempt to keep its real sheqel holdings (real balances) as low as possible, along with a faster circulation of velocity. These additional assets originate in money creation (the growth of the money base) and in incremental short-term sheqel credit from the banking system.

Money creation, as stated, is insignificant: during the period reviewed it was equivalent to only 1.6 percent of GNP, which was a little less than in previous years—1.8 percent in 1982 and 2.1 percent in each of the years 1980–81. To a large extent this phenomenon is, despite the high rate of inflation, the mirror-image of the steady contraction of real money balances and the money base. The money base in relation to GNP diminished steadily from 7 percent or more in 1978¹³ to less

⁹ Long-term credit serves mainly to finance investment, but some of it is used for working capital; there is thus some substitutability between it and short-term credit.

¹⁰ The purchase of assets is equal to the addition to the asset base (the exogenous injection less the leakage via the balance of payments) plus the expansion generated by the commercial banking system.

¹¹ Table VIII-3 shows that the purchase of assets in the first nine months of 1983 was equivalent to 8.1 percent of GNP, but the purchase of bank shares from the public by bank affiliates (see the note to Table VIII-3) has to be subtracted; this reduces the figure to about 4 percent of GNP.

¹² The erosion results mainly from the rise in dollar prices. In 1983 there were not many such price increases, but previously they had ranged around 10 percent a year. In sheqel terms, the rate of real change is also influenced by the movement of the exchange rate in relation to domestic prices.

¹³ This too constituted a decline compared with the early 1970s, when the base was equivalent to 15 percent of GNP.

Table VIII-4
MONETARY POLICY INDICATORS, 1980-83
 (Percent of GNP)

	1980	1981	1982	1983		
				Total	I-III	IV
1. Discount-window loans ^a	-0.1	-0.1	0.3	2.2	1.1	4.0
2. Open-market operations	-0.3	0.6	-0.9	0.1	0.3	0.7
3. Bank of Israel injection generated by other factors	0.6	1.6	0.4	-0.1	0.9	-1.8
4. Injection generated by directed credit ^b	3.6	-0.4	0.1	1.8	1.0	3.3
5. Change in foreign currency credit ceilings	-2.0	1.6	-2.2	-0.5	-0.2	-0.3
6. Change in liquidity ratios on sheqel assets ^c	0.9	0.5	1.6	-1.4	-1.8	-0.1
7. Change in banks' liquidity deficiencies	-1.7	0.1	0.3	0.2	0.9	-1.0
	Percent average nominal monthly increase					
Outstanding short-term bank credit	7.1	5.3	7.3	7.5	5.7	13.1
Outstanding medium- and long-term bank credit ^d	7.7	9.4	10.7	11.4	11.0	12.4
Increase in consumer price index	7.0	6.0	7.2	9.2	7.1	15.7

^a Change in outstanding discount-window loans from the beginning to the end of the period.

^b Includes an adjustment for the transfer of export funds from the Bank of Israel to the commercial banks.

^c The changes in the sources of commercial bank sheqel credit stemming from changes in the liquidity ratios on sheqel assets during the period concerned.

^d A large part of such credit is granted by the government or in accordance with its guidelines.

than 3 percent in the last two years. This can be attributed to the portfolio of linked liquid assets held by the public, which were generated by the enormous public sector deficit financing requirements.

The growth of this portfolio implies that the public has refrained for the time being from satisfying its demand in the commodity market and that the effect of the incremental public debt on domestic demands and the balance of payments has been deferred to the future. The accumulation of linked long-term assets likewise prevents the generation of excess demand, but here too the effect is probably deferred. The more liquid the portfolio, the narrower the scope within which a moderating monetary policy can operate effectively. The liquidity of the portfolio is largely an outcome of the structure of Israel's capital market and the asset yield range allowed by the authorities; the range is very small in the case of foreign currency-linked deposits in particular, and to a lesser extent in indexed bonds. In recent years (until October 1983) an asset that does not constitute a government liability was added to the liquid portfolio—bank shares, whose price was supported

Table VIII-5
DOMESTIC DEFICIT OF THE PUBLIC SECTOR (GOVERNMENT AND
BANK OF ISRAEL) AND ITS FINANCING, 1978-83^a

(Percent of GNP)

	1978	1979	1980	1981	1982	1983
1. Deficit						
a. Public sector domestic deficit, excl. interest paid ^b	6.5	4.6	6.3	10.1	6.1	3.8
b. Subsidy element in concessionary credit ^c	4.3	7.4	6.7	4.4	3.0	2.5
c. Interest on domestic debt ^d	4.3	4.0	4.6	4.6	4.2	4.6
d. Public sector domestic deficit, incl. interest paid (a+b+c)	15.1	16.0	17.6	19.1	13.3	10.9
2. Financing of deficit						
e. Money creation	1.7	1.0	2.1	2.1	1.8	2.3
f. Net growth of domestic debt ^e	14.7	9.5	11.2	13.7	6.5	1.4
g. Purchase of foreign currency by the public	-1.3	5.5	4.3	3.3	5.0	7.2
3. Financial saving^f	13.4	9.0	15.1	16.5	6.1	0.9

^a To analyze how the deficit is financed it is necessary to prepare a consolidated balance sheet of the government and Bank of Israel, for the structure of Israel's capital market is such that the financing mix is largely determined by the private sector's preferences. This precludes a separation, for analytical purposes, between the contribution of the public sector and that of the Bank of Israel.

^b Source: Table VIII-A5, line 1c

^c Government development loans and directed credit granted through the Bank of Israel.

^d Based on the calculated real interest rate on the domestic debt as estimated in Chapter V.

^e The increase in private sector financial claims on the government, including Patam and excluding net credit provided by the government and the Bank of Israel (including discount-window loans).

^f Net increase in the domestic debt, less the increase in private sector liabilities to foreigners.

by companies affiliated with the country's leading banks, thus transforming them into a low-risk asset despite their high real rate of return, which exceeded that of other liquid assets.

Examination of the public's total liquidity in recent years therefore necessitates an analysis of its liquid assets¹⁴ plus bank shares. The real value of this aggregate rose steadily because of new purchases and the high rate of return on such shares. During the first three quarters of 1983 the uptrend came to a halt, and the weight of these securities in the portfolio declined while that of Patam rose. However, the size of the liquid portfolio was such as to enable the public to easily satisfy its incremental demand this year, particularly for consumer durables and imported capital goods.

The high real rate of return on bank shares during the past three years was not accompanied by a corresponding increase in the banks' profitability. It resulted

¹⁴ These consist of sheqel assets, Patam, and tradable government bonds.

from the longstanding practice of supporting their price so as to ensure a high return. This enhanced the public's confidence in the continuation of this trend and also permitted the floating of new issues, although it was clear that this could not go on indefinitely. In the past, whenever the stock market weakened the banking groups succeeded in propping up their shares and later on in disposing of them. The weight of these equities in the public's portfolio rose steadily, and the gap between their price and real value widened, increasing the extent to which the price was bound to decline upon the eventual termination of the process. The supporting of bank shares was fraught with risks, but in view of the dimensions of the problem, which had built up in earlier years, discontinuation of this practice was also bound up with grave risks to the capital market and the financial system (in both Israeli and foreign currency). Reducing the dangers involved in ending such intervention therefore necessitated decisions in other areas, especially the exchange rate.

It was against this background that demand for bank shares underwent a drastic change—a development whose timing was greatly influenced by the expected yield differential between foreign currency-linked and other assets. But the supporting of these shares prevented a dampening of demand, which under normal market conditions should have depressed their value, as happened to nonbank shares from the beginning of the year. As stated, the banks brought in considerable capital from abroad, mainly through affiliated companies, in order to prop up their shares, and in the third quarter of the year these affiliates picked up a substantial amount of shares thrown on the market by the public. This, however, failed to reverse the trend owing to the strong devaluation expectations and the shift to assets linked to foreign currency. At this point the government worked out an arrangement with the commercial banking system which terminated the process and was accompanied by a big devaluation.

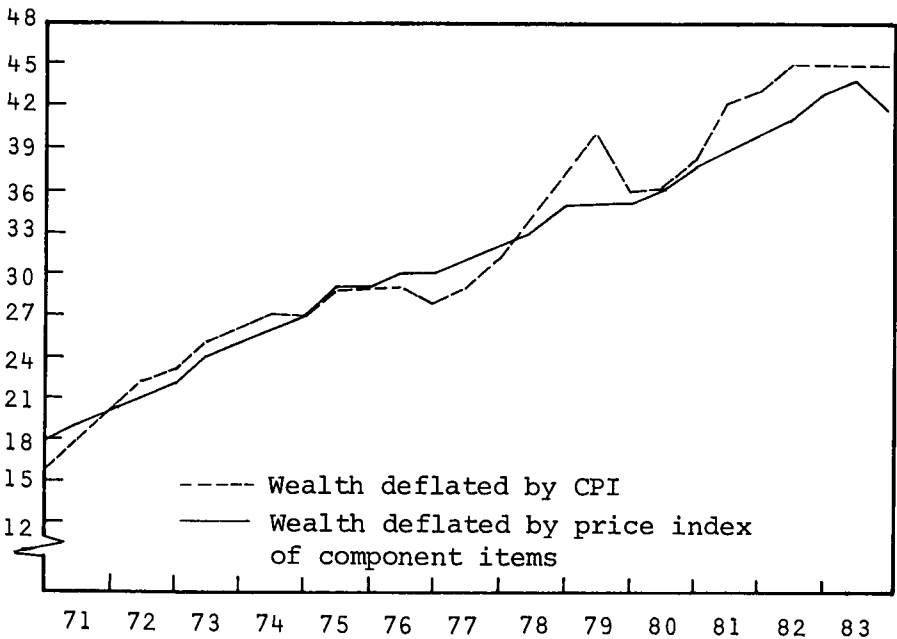
Fourth Quarter of 1983

Until the bank share agreement could be hammered out, the Tel Aviv Stock Exchange was closed for two weeks. During this period the parties finalized the arrangement, which was intended to prevent the jolting of the capital market by guaranteeing a minimum price for such shares in the future based on their dollar value on October 6, 1983. As a result of this arrangement and as an integral part of it, the supporting of bank shares ceased and the government assumed an additional future commitment which endowed these securities with properties similar to those of government bonds.¹⁵ The size of this future burden on the government budget cannot be ascertained at this stage, and it depends on how well the commercial banking system will fare in the years ahead.

Halting the support of bank shares greatly diminished their liquidity. When the arrangement went into force the present value of the shares fell 30 percent

¹⁵ Under certain conditions these "bonds" may become a direct government liability, in which case it will increase the domestic debt.

Figure VIII-2
THE PUBLIC'S WEALTH, 1971-83
 (IS billion, at Dec. 1975 prices)



overnight (10 percent nominally). Upon the resumption of trade the government purchased a large amount of shares disposed of by the public.¹⁶ This was to keep their price from tumbling, but selling pressure was so great that in the first days of trading the shares slumped 16 percent nominally, and by the end of the year they lost about half their real value. This shrank the public's financial portfolio by 16 percent and its financial wealth by 15 percent.

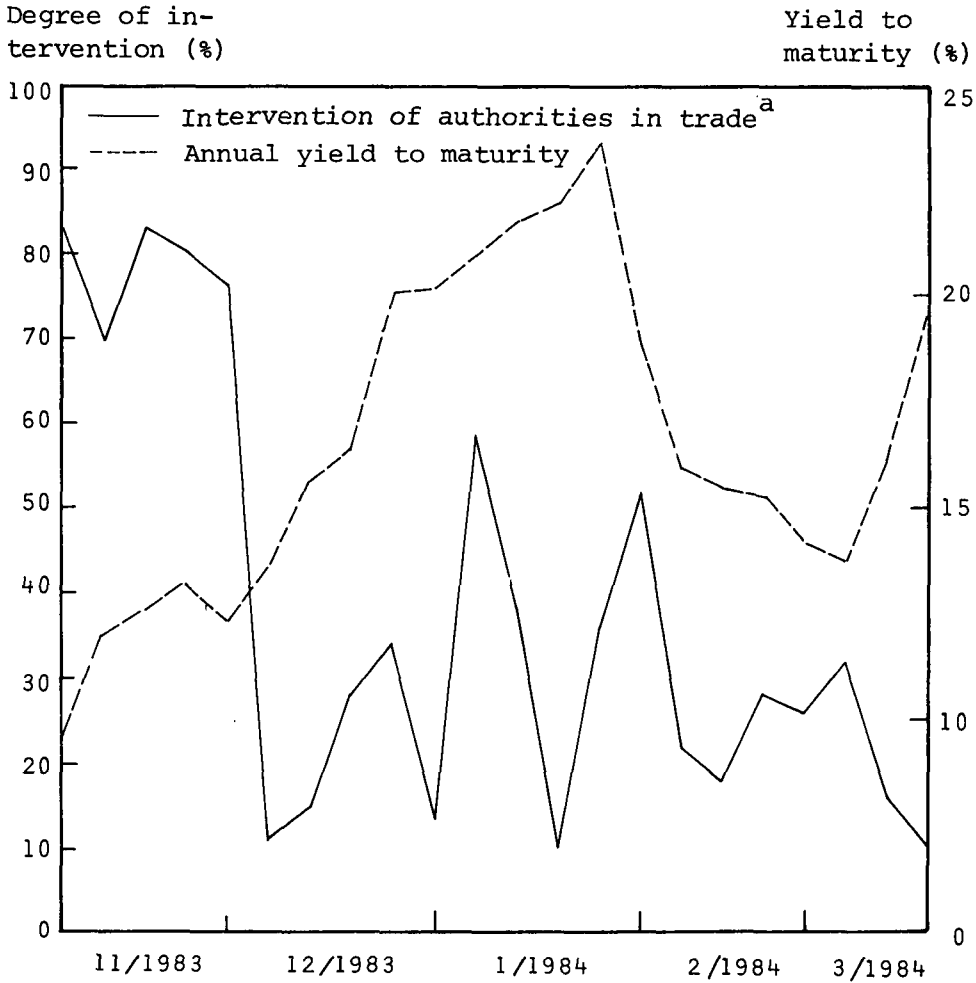
Together with the closure of the Stock Exchange, and in order to stem the run on foreign currency, the sheqel was devalued by 23 percent and the daily depreciation was stepped up appreciably; in addition, controlled prices of basic goods and services were raised steeply. These measures led to an unprecedented jump in consumer prices in October (21 percent) and sharp rises also in the following months; in the final quarter of the year the average monthly inflation rate reached 15.9 percent, and in the first quarter of 1984 it came to 12.5 percent.

The unsettling of the capital market triggered an adjustment of financial and real demands. This process was fueled by the liquidity injection resulting from the large-scale government purchase of bank shares from the public—IS54 billion worth, equivalent to 11 percent of the quarterly GNP. The purchases were made,

¹⁶ The purchases were made through a government company, which has undertaken to sell the shares to the bank affiliates whenever its holdings exceed 4.9 percent of the total shares of any bank.

Figure VIII-3

YIELD TO MATURITY OF "ARRANGEMENT" BANK SHARES AND INTERVENTION OF AUTHORITIES IN THEIR TRADE



^a Includes purchases by social insurance funds at the end of November 1983 under a special one-time arrangement.

as stated, to prevent the collapse of bank share prices and the harming of individual savers, and also to bolster confidence in the capital market. They facilitated the switch from bank shares to foreign currency-linked assets, including foreign banknotes. The magnitude of the exogenous injection engendered by the budget deficit in this period was similar to that in the first three quarters of the year. However, because of the dislocation of the capital market this injection was not channeled to long-term assets, but was diverted entirely to the acquisition of foreign currency and sheqel deposits denominated in foreign currency, with preference accorded to the more liquid assets (Patam demand deposits). During

this period the public acquired IS62 billion worth of foreign currency (equivalent to 12.5 percent of the quarterly GNP), which implied a large balance of payments absorption. This absorption, together with the continued switch from sheqel assets to Patam, resulted in an accelerated 11 percent real contraction of domestic credit during these three months.

The total exogenous injection generated by the public sector and the Bank of Israel (excluding bank share purchases) was equivalent to roughly 12 percent of GNP during this period—a higher figure than in the first three quarters of the year (10 percent of GNP). The growth of the injection stemmed partly from the larger volume of directed credit granted and partly from the expansion of discount-window lending. Discount-window loans were stepped up during the two weeks when the Stock Exchange was closed and the shortage of liquidity was particularly acute, and also toward the end of the year in order to enable the banks to reduce their liquidity deficiencies. The larger exogenous injection during this period also permitted the expansion of the sheqel base in the monetary system, but not enough to entirely offset the erosion caused by the steep rise of prices and the squeeze on the sources of domestic credit.

The exogenous injection, which in 1982–83 was smaller than in previous years (relative to the growth of the economy), was not reflected by any slowing of inflation during the first nine months of 1983, and by the same token the additional liquidity pumped into economy during the fourth quarter was not the cause of the acceleration of inflation in the final part of the year, for the connection between the movement of prices and an exogenous injection is a more indirect one. Admittedly such an injection largely reflects the government's demand surplus, but not all of the latter finds expression in excess domestic demand which pushes up the price level. An exogenous injection reflects, as stated, the composition of the government's financing of its purchases of goods and services other than through taxes. In the past a substantial part of the injection resulted in the growth of the domestic debt, but this source of funding was reduced this year. We cannot fully explain the readiness of the public to forgo consumption in the present year and to save the extra money which the exogenous injection put into the economy in the form of government liabilities, and it is not certain that the public will persist in this behavior. It should nevertheless be borne in mind that such saving prevented the creation of excess demand in the various markets, and so it has not influenced the rise of prices so far.

The public also made goods and services available to the government in exchange for money creation, which was required for restoring the inflation-eroded purchasing power of its money balances. This source of financing has been equivalent to about 2 percent of GNP each year. The rest of the deficit was covered by increasing the external debt, and it reflected the diversion to the foreign market of excess demand for products traded internationally, a trend that grew stronger in

the last two years. The incremental demand that was not channeled to imports pushed up the prices of nontradable commodities faster than those of tradables; i.e. it resulted in a real appreciation of the sheqel. It follows that there is not necessarily a direct connection between an exogenous injection and the rise of prices; even that part of the injection which *ex post* is diverted to money creation is not indicative of a direct connection with inflation (see Table VIII-A2). As stated, given the structure of the capital market in Israel, money creation is primarily a function of the public's preferences, and the rate of increase in prices largely dictates its need for a nominal addition to the money base.¹⁷ The price increases are related more to such nominal magnitudes as the exchange rate, wages, and government-controlled prices, as well as to the interaction between them and the public's expectations. But without the incremental domestic liquidity it would not have been possible to fuel inflation to such an extent. In the past, whenever unexpected price rises (as in 1974 and 1979) eroded the public's wealth and reduced its liquidity,¹⁸ the authorities found it hard to let the effect of this automatic squeeze be fully manifested in the balance of payments, for this was bound to cause, at least temporarily, an increase in unemployment. The authorities therefore injected additional money into the economy, which staved off the likely creation of unemployment and a real devaluation. The October developments resulted in an unprecedented contraction of the public's financial wealth. This in turn depressed demands and employment, and let part of the nominal devaluation be translated into a real devaluation. However, the effect of the diminution of liquidity, which accompanied the rise of prices and was reflected *inter alia* by a real domestic credit squeeze, was partly offset by a further exogenous injection during this period. This injection, which was intended to prevent a severe dislocation of the capital market and economic activity, nullified some of the potential positive effect of the October events on the balance of payments.

The accelerating inflation during the past decade has not increased the government's long-term financing capability. On the one hand, it has enabled the government to fund part of its budget by printing money and selling linked financial liabilities which serve as a substitute for money ("quasi-money"). On the other hand, the government has granted unlinked loans, whose real value has been eroded by inflation, increasing its net indebtedness to the public.

It will therefore be seen that the cumulative quantitative effect of the government deficit has not yet found its full expression, and that inflation is only one small manifestation of it. Actually its principal implication has been deferred to the future, whether in the form of a swelling net short- and long-term domestic

¹⁷ The nominal addition to the money supply over and above the addition to the money base originates in the sheqel credits extended by the commercial banking system, in accordance with the required liquidity ratios and the actual deviations therefrom (liquidity deficiencies).

¹⁸ The loss of wealth was negligible, and some even maintain that there was no loss at all because of the asymmetrical linkage of the government's assets and liabilities.

debt (which has grown in real terms with inflation) or an increased external debt.¹⁹ The government must be alert to the fact that the ongoing budget deficit aggravates the problem.

The year reviewed, in particular the first nine months, saw an acceleration of demands, especially for imports but also in the domestic market. This development was strongly influenced by the prevailing expectations of a change in exchange rate and tax policy,²⁰ and it was made possible by the public's shift from financial assets, which were accumulated on a large scale in recent years, to tangible assets—consumer durables and capital goods—in spite of the reduction of short-term domestic credit and the rise in the real bank lending rate. The more buoyant demands contributed to the expansion of production in the first three quarters of the year. The latter occurred despite the increased cost of credit, and can probably be attributed in part to the growth of outstanding medium- and long-term credit, some of which is used for short-term financing.

Monetary developments in the final quarter of the year, which were reflected by a sharp decline in the public's wealth, the reduction of its liquid portfolio, and a credit squeeze, apparently had a dampening effect on demands and economic activity, which has not yet fully run its course.

¹⁹ Deferral of a solution increases the magnitude of the problem by the level of the real interest on the domestic and external debts.

²⁰ The public expected a stiffening of import taxes and the imposition of a levy on financial assets.