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### SAVING IN INFLATIONARY TIMES: HOW THE ISRAELIS DO IT

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#### Introduction

For the last three years Israel has suffered three-digit inflation and the Israeli economy is still going strong. In spite of high inflation, the economy has not collapsed and Israel remains a full fledged democracy. There are no demonstrations in the streets, individuals seem to enjoy life and, on the surface, nothing is wrong with the economy.

This is not an accurate reflection of what is happening in the Israeli economy. Although inflation has not hurt most individual Israelis, it does cause economic distortion. A misallocation of resources is taking place. Rapid inflation encourages consumption, largely consumption of imported goods, while it discourages investment, especially investment for export production. Thus, as far as the structure of the economy is concerned, there is no doubt that a major retreat has been registered in the recent years.

Outsiders, especially foreign visitors, wonder how this country's economy survives in view of such dramatic inflation. The accepted explanation is that nearly all segments of the population are protected against inflation. Thus, as individuals, they do not suffer from inflation. What safeguards them against being hurt by inflation is the comprehensive indexation introduced into nearly every sector of the economy.

Some observers go so far as claiming that inflation of 10%-20% in the United States and the United Kingdom is much more harmful to the general public, employees, wage-earners, savers, and depositors, than is a three-digit inflation in Israel, where everything is linked and everybody is protected. Everybody except the national economy, the structure of which is getting more and more distorted.

#### The Public Sector

One of the areas in which, in spite of rapid inflation, the Israeli economy has registered commendable progress is savings. In contradistinction to all theoretical forecasts Israelis have continued to save a substantial portion of their disposable income. By accepted definition national saving is composed of private sector savings and public savings. Private savings include corporate saving and personal savings.

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Public saving is the excess of government and other public institution revenues over their expenses. As is well known, public savings in Israel are non-existent. The government deficit is probably the main cause and source of inflation. It is very difficult to exactly determine the government deficit spending and excess expenditure over revenue, although it is known to be very substantial. Excess government spending over incoming funds has been estimated at some 30 billion Israeli shekels in 1981. The government raised some IS 15 billion through the sale of bonds to the public and to pension funds. This can be considered the government's net negative saving.

### The Private Sector

#### Corporate Savings

Corporate savings are the total net profits of companies not distributed as dividends. The magnitude of corporate saving has not been officially determined but it is growing. Profitability of business is on the increase and, thanks to certain income tax concessions in the last two years, one can conclude that corporate savings are positive and on the increase.

One of the main problems of the corporate sector in Israel is that it is paying taxes on inflationary profits. No penetrating research has been carried out in this field, however it is well known that companies save (namely they have profits which are not distributed as dividends) in nominal terms. It is not clear whether they also have profits in real terms and consequently real savings. To protect themselves against paying income tax on inflationary profits, companies invest their reserves in bonds and shares, the appreciation of which is not subject to tax. A new proposal to partially tax these profits is now under consideration. (See Dr. Y. Gabbay, "Taxation Under Inflationary Conditions," Economic Paper No. 1, Jerusalem Institute for Federal Studies.)

#### Personal Savings - Contractual

By far the main source of saving is personal and it is impressive by any yardstick. Personal saving out of national income was 21% in 1976, 23% in 1977, 24% in 1978, 21% in 1979 and 23% in 1980 and may have been slightly higher in 1981. But in calculating saving in Israel one should take into account the amounts received by Israeli citizens as German restitution payments, and other receipts from abroad, a part of which is also saved. Thus total savings out of domestic income and out of unilateral transfers from abroad may reach as much as 30%. Thus a remarkable proportion of the national income as well as a substantial amount in absolute terms, is saved in Israel in spite of one of the worst inflation rates in the world. It is customary to divide personal savings into three sub-groups: a) compulsory saving - saving imposed by the government, like War Loans and Absorption Loans. This type of personal saving which used to be very important several years ago has diminished a great deal recently and has consequently lost its importance.

b) Contractual savings - by far the most important element of personal saving in Israel. Contractual savings means personal savings in the form of long term contracts. This can take the form of saving for provident and pension funds where employee and employer contribute agreed amounts according to a contract. The amounts usually represent 5% of the salaries contributed by the employee and 5% contributed by the employer to the provident fund and 8-1/3% (a month per every year) contributed to the severance pay fund. Altogether 18-1/3% (in many instances still only 16%) of wages and salaries in the country are saved month by month. Nearly all employees in the country, and

large numbers of the self-employed are members of provident and pension funds. (From that amount one should deduct payments to those who have reached retirement age or left their jobs.) Nearly all the proceeds of the provident and pension funds are invested in government or bank indexed linked bonds (92%) which are termed "approved investments" by the authorities. The rest of the money may be invested in shares, property or loans to members, but is partly invested in bonds. In this way the members of the provident and pension funds can rest assured that their savings are protected against misinvestment and against inflation. In addition to the provident and pension funds run by the labor sector, commercial banks have established provident funds for the self-employed, and for employers who are not members of pension funds. These provident funds have met with very high success and are growing quickly. The funds run by the commercial banks may accept additional sums from members. It turns out that these funds have become an excellent way of safeguarding one's savings against inflation.

Another form of contractual saving is life insurance. Although not as widespread and important as in the United States and United Kingdom, it is growing very rapidly. Its growth is a result of a unique feature of Israeli insurance: life insurance policies are linked to the cost-of-living index. So are, of course, the premiums that the insured pay every year. It goes without saying that at inflation rates of three digits, the insurance industry would have collapsed unless it had created linkage safeguards.

Still another form of personal contractual savings is the special saving schemes offered by the commercial banks. These special saving schemes are linked to the cost-of-living index (principal and interest) and recently to the rate of exchange of the United States dollar as well. A substantial amount has been accumulated in these special saving schemes, the principal of which is fully linked while the interest rates of 3-5% are usually not. The banks and the treasury have supplemented the ordinary terms of the schemes with special benefits to attract savers. At times, special offers have been made to savers that have met with considerable success. Mortgage payments can also be classified as savings. If this concept is accepted, the monthly mortgage payment should be considered the most important element of contractual saving.

#### Personal Savings - Voluntary

c) The third category of personal savings is voluntary personal savings which are defined as that part of disposable income which is not saved by compulsory or contractual arrangement. The most popular form of voluntary savings in Israel in recent years has been the purchase of linked debentures. These debentures, or bonds, are issued either by the government or by leading financial institutions (a few issues were made by non-government, non-financial institutions in some cases as convertible bonds, meaning bonds to be converted into shares of the company, but these are very rare). The principal and interest are usually linked to the cost-of-living index. In the majority of cases the linkage is a partial one; compensation to savers is 80% to 90% of the increase in the cost-of-living index.

These index-linked bonds are extremely popular with individuals as well as companies because they preserve the real value of the original investment and the real interest that was paid, and because of their high liquidity since the Bank of Israel is apparently prepared to buy and sell any amount of such bonds. No wonder then that the issue of index-linked bonds has reached very high levels: some 40 billion Israeli

shekels held by the public (December 1981) in addition to larger amounts held by provident and pension funds, banks and other institutions.

Several years ago in view of these deficiencies, the authorities decided to gradually reduce the rate of linkage from 100% to 90%-80% and planned to continue to reduce it to 70%. But the new Likud administration has returned to full linkage of 100%.

From 1979-82 the pressure to redeem government bonds has weakened somewhat since in 1974 the bonds' maturities were lengthened from 5 to 10 years. This means that in two years the government will have to pay the public huge amounts as the bonds issued ten and five years ago reach maturity. The government will have to make plans to avoid huge deficits either by providing a surplus in the budget or by offering especially attractive terms to those whose bonds mature.

In the last two years the linked bonds have been less popular than commercial bank shares as a form of voluntary saving. It is not easy for those who are not familiar with the Israeli economy to visualize the widespread popularity of bank shares. Recently, the public in general has preferred bank shares to linked debentures. The banks have seen to it that the quotations for bank shares would go up at a slightly higher rate than the cost-of-living index. The popularity of the banks in Israel, their public image as powerful, rich institutions have encouraged general acceptance of the notion that investment in bank shares means participation in bank profits and is as good as, if not better than, cost-of-living index bonds issued by the government. In the last year more than IS 4 billion were added to savings in the form of bank shares. Their market value is substantially higher.

There are a number of other forms of voluntary savings. Their scale is rather small except for saving in the form of purchase of new apartments. Israelis buy apartments rather than rent them. The purchase of a flat should be considered negative saving depending on the definition.

Estimates of personal new savings in Israel in 1981 put the sum at IS 17.5 billion (over 1.1 billion United States dollars). Approximately 18 billion shekels were in provident and pension funds and special saving schemes in the banks. Saving in the form of banks shares were put at IS 4 billion and other shares at IS 2 billion: altogether some IS 24 billion. At the same time there was a decline in savings in the form of foreign currency deposits purchased by Israeli citizens and in the purchases of newly issued linked bonds. The decline is estimated at IS 6.5 billion - thus the net financial saving in 1981 is estimated at IS 17.5 billion.

Although the introduction of the linkage system has made possible an economic miracle - substantial savings in a highly inflationary economy - it has some basic deficiencies: it contributes to the perpetuation of the inflationary trends in the economy; it also prevents the adoption of a restraining monetary policy. The population has accumulated an enormous amount (estimated at IS 3 trillion). When dealing with such accumulated savings, which are partly liquid, it is very difficult to pursue an effective monetary policy.

Savings and Income in Israel

(in millions IS)

	<u>1978</u>	<u>1979</u>	<u>1980</u>
Disposable private income of all sources:	20,886	37,732	84,843
Private Savings from domestic sources	4,625	7,332	17,663
"        "        "    all        "	6,212	10,022	23,456
"        "        "    domestic    " (in %)	24.0	20.9	23.3
"        "        "    all        " (in %)	29.7	26.6	27.6

Source: Bank of Israel - Annual Report 1980.

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