

2. RESIDENT EXTERNAL INVESTMENT

a. Main developments

The balance of Israel's assets abroad climbed by \$4.3 billion in 2001 and came to \$70.2 billion, due to the decrease in the prices of tradable assets abroad (Figure 3.2.1). External investments declined steeply relative to 2000 and settled at their lowest level in the past five years (Table 3.2.1).⁶

The decline in external investment traces mainly to external developments in 2001—the global economic slowdown, reflected in less global demand for high-tech products, and the slump in capital markets.

In recent years, much external investment was a mirror image of nonresident investments in Israel; global developments caused it to contract severely. External developments affected the various components of the external portfolio in different degrees of intensity, depending on the investment horizon and the share of high-tech industries in the various components.

The direct and portfolio components of investment fell steeply in 2001 relative to 2000. However, while the level of direct investment corresponded to the long-term trend, portfolio investment, which strongly reflected nonresident activity—acquisition

Total resident external investment was \$4.8 billion in 2001—the lowest level in the past 5 years.

Table 3.2.1
Resident External Investment, 1997–2001

						(\$ billion)	
	1997	1998	1999	2000	2001	Change in 2001	of which Change in prices
Movements							
Total direct investment	9.4	6.1	8.0	9.9	4.8		
<i>of which</i> High-tech	0.5	1.6	1.2	4.9	2.3		
Direct investment	0.7	1.1	0.9	2.9	1.2		
Portfolio investment	0.0	0.0	0.9	2.7	0.7		
Other investment	–0.5	3.3	5.3	3.5	3.0		
Investments in forex reserves	9.2	1.7	1.1	0.9	–0.1		
Balance (end of period)							
Total investment	43.4	51.2	57.6	65.9	70.2	4.3	–0.5
Direct investment	4.2	5.9	6.6	8.7	9.8	1.1	–0.2
Portfolio investment	3.1	3.5	5.2	8.2	8.7	0.5 ^a	–0.8
Other investment	15.8	19.1	23.3	25.8	28.6	2.8	0.0
Investments in forex reserves	20.3	22.7	22.5	23.2	23.2	0.0	0.0

^a Including \$1.1 billion in other adjustments stemming from forward transactions and investment in shares.
SOURCE: Reports from banks to the Controller of Foreign Exchange.

⁶ Israel's assets abroad do not include assistance funds that were delayed to early 2002. (The Central Bureau of Statistics charged this money to 2001.)

Direct investment corresponded to the long-term uptrend.

Resident external deposits increased by \$2.8 billion, even though overseas issues decreased.

of companies and their knowledge in return for tradable shares—declined precipitously in tandem with the drastic decline in this form of nonresident activity. Some of the decrease in portfolio investment was offset by insurance companies' investments in foreign securities, an activity permitted to them in 2001 for the first time.

Net external deposits of the nonbanking private sector increased by \$2.8 billion, even though overseas issues by Israeli companies, which had served as a source for the uptrend in deposits in recent years, decreased severely.

The increase in resident external deposits in 2001 originated in transfers from deposits in Israel and from export proceeds received abroad in order to maximize the rate of return. This phenomenon, more in evidence in 2001 than before, is part of the enhancement of market efficiency that reflects the learning process since the deregulation of activity in foreign currency.

Official foreign reserves, kept with the Bank of Israel, were stable mainly due to the decline in global interest rates, which reduced interest receipts relative to the previous year but also resulted in capital gains.

Figure 3.2.1
Total Resident External Investment, 1997-2001

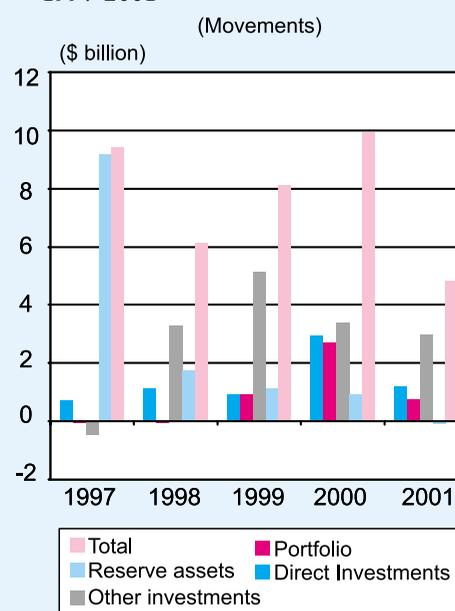


Table 3.2.2
Direct Resident Investment, 1997-2001

	1997	1998	1999	2000	2001	Change in 2001	of which Change in prices
(\$ billion)							
Movements							
Total direct investment	0.7	1.1	0.9	2.9	1.2		
of which High-tech	0.7	1.4	0.4	2.0	0.3		
Nonbanking private sector	0.6	1.1	0.9	2.9	1.0		
Banks	0.1	0.0	0.1	0.1	0.2		
Balance							
Total direct investment	4.2	5.9	6.6	8.7	9.8	1.1	-0.2
Nonbanking private sector	3.0	4.6	5.3	7.4	8.3	0.9	-0.2
Banks	1.2	1.2	1.3	1.3	1.5	0.2	-

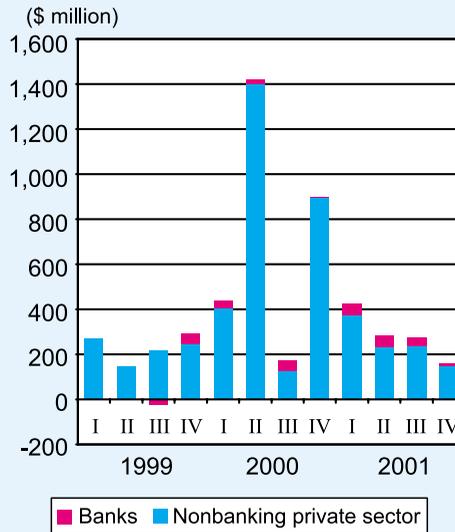
SOURCE: Reports from banks to the Controller of Foreign Exchange.

b. Direct investment

The balance of direct external investment increased by \$1.1 billion this year, as continued investments by foreign companies were partly offset by a decrease in the prices of subsidiaries' shares traded abroad. Direct investment in 2001 fell short of the record level in 2000 but corresponded to the trend since 1997.

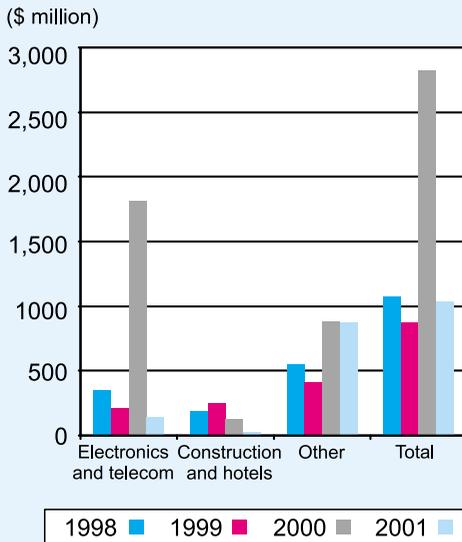
Most direct investment is made by the nonbanking private sector but a small portion is composed of banks' investments in subsidiaries abroad. The steep decrease in investment this year relative to 2000 traces largely to the high-tech crisis, which led to fewer acquisitions of companies abroad. Investments in these firms are part of transactions with foreign companies that acquired Israeli firms and

Figure 3.2.2
Direct Resident External Investment, 1999-2001



SOURCE: Banks' reports to Controller of Foreign Exchange.

Figure 3.2.3
Direct Investment of Nonbanking Private Sector, by Industry of Investor, 1998-2001



SOURCE: Banks' reports to Controller of Foreign Exchange.

paid for them, in part, by transferring their own shares to the company acquired—a procedure that makes Israel residents into principals in foreign firms. In 2000, about half of total direct investment was performed in this manner (Figure 3.2.2).

Analysis of the investment by industries points to a steep decrease in direct investments by firms in the electronics and telecom industries, in which much of high-tech is concentrated. These industries accounted for one-third of total direct investment this year as against three-fourths in 2000. The decrease was brought about by the precipitous decline in global demand for high-tech products and an increase in uncertainty about technological developments that had been expected. External investments by construction and hotel companies also contracted severely

in 2001 relative to previous years and came to negligible sums as against a record level of \$250 million in 1999. The decline was occasioned by the companies' financial considerations and by their taking loans from foreign subsidiaries instead of financing their activities from domestic sources. The payback of loans is defined as the realization of an external investment (Figure 3.2.3). Service and commerce industries and holding companies continued to invest in 2001 at approximately the 2000 level.

Box 3.2.1
Characteristics of Direct External Investments of the Nonbanking Private Sector in the Past Decade

Direct external investments of the nonbanking private sector increased over the past decade from \$300 million in 1990–1992 to \$600 million in 1993–1997 and \$1 billion since 1998 (all figures in annual average terms). The 2000 figure, \$2.8 billion, was an outlier that occurred due to unique market conditions—as reflected in high price levels on foreign stock exchanges—that made it possible to acquire foreign companies in large transactions involving exchanges of shares, i.e., payment in the 'coin' of tradable shares of the acquiring Israeli firms.

In the first half of the 1990s, external investments were meant mainly to establish direct-marketing companies in export target countries, and most such investments were small in scale. In the second half of the decade, as globalization accelerated and foreign-exchange controls were rescinded, increasingly large sums were invested in the acquisition of marketing and production systems. These investments, designed to increase market share and boost sales, are typically large—\$50 million or more per transaction. Analysis of the distribution of direct investments by main industries shows that about two-thirds are performed by electronics and telecommunications, chemicals, and construction and hotel companies.

Some \$4 billion was invested by electronics and telecom companies in the past decade, two-thirds of which since 1998. This level of investment was part of the growth process of this industry group, which doubled its exports between 1998 and 2000. Direct investments by chemical companies, \$1.2 billion in the period reviewed, are noted for severe concentration, each of a small number of companies investing a large sum. Hence, investments by this industry group show strong year-on-year volatility. Annual external investments by construction and hotel companies tripled over the past three years in response to the lifting of investment restrictions and the ongoing domestic real-estate slump, which prompted firms to move contracting and income-generating (leasing) projects to other countries. During these three years, construction and hotel companies invested \$0.5 billion in foreign real estate, in cumulative terms. This sum, reflecting the amount of capital removed from Israel, constituted 10–25 percent of the value of the properties acquired; the rest was financed from local foreign sources.

c. Portfolio investment

Portfolio investment equaled \$8.7 billion at the end of 2001—\$6.6 billion in bonds and \$2.1 billion in shares. The \$0.5 billion increase in the portfolio was composed of a \$0.5 billion decrease in shares—mostly due to the price decline in high-tech shares, which make up much of the resident portfolio—and a \$1.0 billion increase in resident holdings of bonds.

Gross portfolio investment (shares and bonds) was \$1.6 billion. Net investment, after a \$0.9 billion offset of receipts from forwards transactions, was \$0.7 billion. Most of the investments were made by Israeli firms, which built up the bond component

Table 3.2.3
Resident Portfolio Investment, 1997–2001

	1997	1998	1999	2000	2001	Change in 2001	(\$ billion) of which Change in prices
Movements							
Total portfolio investment	0.0	0.0	0.9	2.7	0.7		
<i>of which</i> High-tech	0.0	–0.1	0.1	2.0	0.8		
Foreign shares	0.0	–0.1	–0.1	1.5	0.2		
Foreign bonds	0.1	0.3	0.8	1.9	1.4		
<i>of which</i> Banks	0.0	0.3	0.7	1.0	–0.1		
Nonbanking private sector	0.1	0.0	0.2	0.9	1.5		
Forward transactions	–0.1	–0.2	0.1	–0.7	–0.9		
Balance							
Portfolio	3.1	3.5	5.2	8.2	8.7	0.5	–0.7
Shares	0.4	0.6	1.4	2.6	2.1	–0.5	–0.7
Foreign bonds	2.7	3.0	3.8	5.6	6.6	1.0	–
<i>of which</i> Banks	6.7	7.8	7.9	8.1	3.7	–4.4	–
Nonbanking private sector	1.4	1.9	4.0	5.6	2.8	–2.8	–

SOURCE: Reports from banks to the Controller of Foreign Exchange.

of their portfolios at the expense of the deposit component, which they downsized to maximize their rate of return in view of the decline in deposit interest rates. The increase in investment also reflects the entry of institutional investors, mainly insurance companies, whose external investment restrictions were lifted this year (see Figure 3.2.4).

(1) The bond portfolio

The portfolio of foreign bonds (Figure 3.2.5) is held in greater part by the banking sector (\$3.7 billion) and the nonbanking private sector (\$2.8 billion).

Banks use their foreign bond holdings, like their external deposits, to safeguard surplus forex liquidity. In 2001, they drew down their portfolio of foreign bonds slightly after building it up in 1998–2000. (See discussion of banks' deposits below.)

The nonbanking private sector's portfolio investments in foreign bonds were smaller in 2001 than in 2000 due to activities in contrasting directions. Some companies that had made share issues abroad and invested the proceeds in bonds sold the bonds this year and transferred the proceeds to Israel to finance their domestic activity. Other companies—including insurance companies—invested \$1.5 billion in bonds to improve their return in view of the decline in global interest rates on deposits indexed to and denominated in foreign currency.

Insurance companies held \$200 million in foreign securities at the end of 2001, mostly in foreign bonds. However, these companies have a large investment potential, some of which will probably be fulfilled in the future. The insurance companies' total portfolio, including forex assets in Israel, makes up for about one-

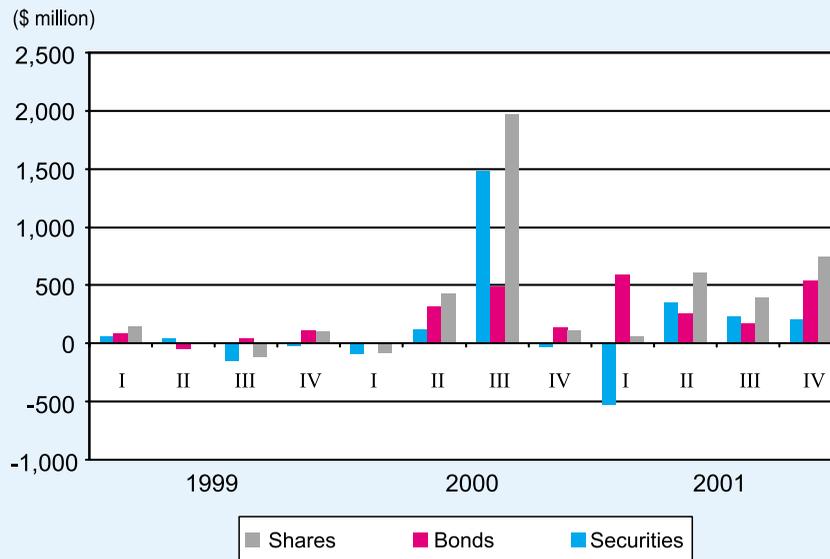
In May, insurance companies were allowed to begin investing abroad, and by year's end they amassed a \$200 million portfolio of foreign securities.

Figure 3.2.4
The External Portfolio, 1997-2001



SOURCE: Banks' reports to Controller of Foreign Exchange.

Figure 3.2.5
Foreign Securities Portfolio Investments, by Quarters, 1999-2001



SOURCE: Banks' reports to Controller of Foreign Exchange.

fourth of total institutional investments. The deregulation of institutional investors' external activity continued in 2001, and in May insurance companies were allowed to begin investing in foreign securities. (For a detailed discussion, see Part 2, Chapter 2.)

(2) *The share portfolio*

The share portfolio decreased by \$0.5 billion, as a \$0.7 billion loss occasioned by the downside in prices of foreign shares was offset by \$0.2 billion in net investment. In previous years, the share portfolio grew largely because residents sold companies that they owned to foreign companies in return for shares in the acquiring companies, most of which were high-tech firms. This year, share acquisitions came to a total of \$0.2 billion. Some of this sum was obtained in one transaction carried out in the manner described above; a smaller portion was derived from share purchases by insurance companies and others.

d. Other investment

Two additional external activities of banks and the nonbanking private sector—credit to nonresidents and deposits with foreign banks—are classified as 'Other Investments.' Total net movements in other investments were \$2.9 billion in 2001: \$0.8 billion in credit to nonresidents and \$2.1 billion in resident deposits with banks abroad.

The banks' activity in these two fields (credit and deposits) originated mainly in sources-and-uses considerations, whereas the nonbanking private sector's motive for its investments, especially in deposits abroad, was the spread between yields in Israel and abroad in deposits indexed to and denominated in foreign currency.

The banks downsized their deposits abroad—which they use as a source for credit (to residents and nonresidents).

Table 3.2.4
Other Resident External Investment, 1997–2001

						(\$ billion)
	1997	1998	1999	2000	2001	Change in 2001
Movements						
Total other investment	−0.4	3.3	5.1	3.4	2.9	
<i>of which</i> High-tech	−0.3	0.3	0.7	0.9	1.2	
Credit to nonresidents	1.2	1.9	2.6	1.5	0.8	
Deposits with foreign banks	−1.6	1.4	2.5	1.9	2.1	
<i>of which</i> By banks	−1.9	1.0	0.3	0.4	−0.6	
By nonbanking private sector	0.2	0.3	1.9	1.6	2.8	
Balance						
Total other investments	15.8	19.1	23.3	25.8	28.6	2.8
Credit to nonresidents	7.5	9.1	10.8	11.5	12.3	0.8
Deposits with foreign banks	8.3	10	12.5	14.3	16.3	2.0
<i>of which</i> By banks	6.7	7.8	7.9	8.1	7.4	−0.7
By nonbanking private sector	1.4	1.9	4.0	5.6	8.4	2.8

SOURCE: Reports from banks to the Controller of Foreign Exchange.

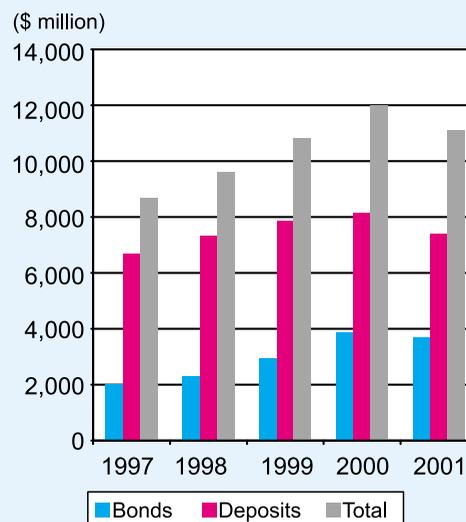
Credit to nonresidents from the nonbanking private sector, \$0.5 billion in 2001, is composed of customer credit and financial credit to nonresidents. Additionally, Israeli banks made more credit available to nonresidents than in 2000, the added increment being issued mainly to several overseas holding companies that own Israeli firms.

The balance of banks' deposits abroad decreased in 2001 after having increased in previous years. The contraction of deposits, in addition to the decline in the banks' portfolio of foreign bonds (as described above), was meant to finance the banks' forex uses, especially foreign-currency credit to residents and nonresidents. The banks behaved this way in view of the decline in nonresident deposits, which had formerly been the main source for these activities (Figure 3.2.6). (For detailed discussion, see Part 2, Chapter 3.)

The nonbanking private sector deposited larger sums abroad in 2001 than in past years.

Deposits of the nonbanking private sector with foreign banks continued to increase in 2001 and by a larger increment than in 2000. The increase in the balance of deposits abroad, despite fewer overseas issues—which had once been the main source of growth in overseas deposits—flowed from a redirection of depositing activity from Israel to abroad by holding companies and export firms, which deposited proceeds abroad (Figure 3.2.7) mainly to maximize their rate of return.

Figure 3.2.6
Balance of Deposits with Foreign Banks and Balance of Foreign Bonds of Banks, 1997-2001



SOURCE: Banks' reports to Supervisor of Banks

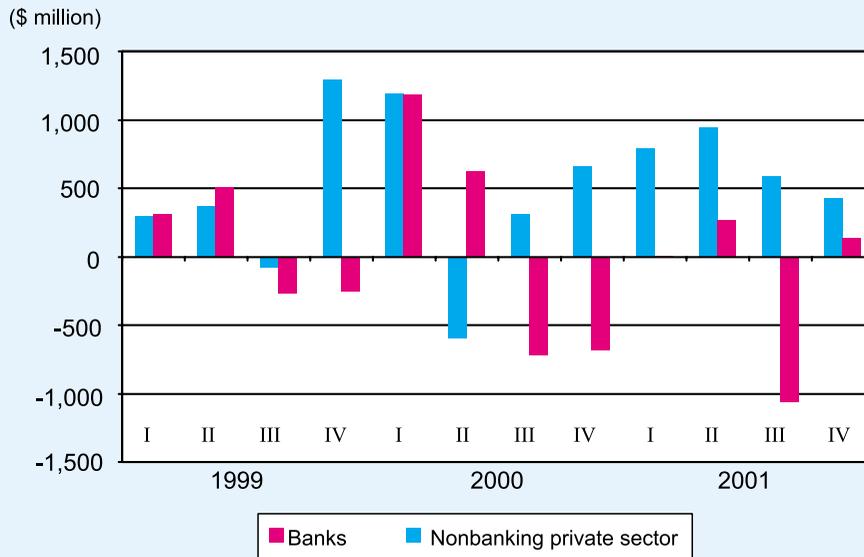
Table 3.2.5
Balance of Deposits, by Type of Depositor, 1999-2001

	(\$ billion)			
	1999	2000	2001	Change in 2001
Issuing companies	1.6	1.9	1.1	-0.8
Export companies	1.9	2.4	3.9	1.5
Holding and other companies	0.0	0.3	0.7	0.4
Other companies ^a	0.0	0.2	1.8	1.6
Individuals	0.5	0.8	0.9	0.1
Total	4.0	5.6	8.4	2.8

^a Including individuals and unclassified.

SOURCE: Reports by companies to the Controller of Foreign Exchange.

Figure 3.2.7
Resident Investment in Deposits Abroad, 1999-2001



SOURCE: Banks' reports to Controller of Foreign Exchange.

Box 3.2.2 **Taxation of External and Forex Activity**

Taxation of external and forex activity is not neutral in terms of its impact on the currency composition (NIS-forex) and the geographical composition (domestic/external) of the public's portfolio of financial assets. A neutral tax system in these respects would mitigate distortions and discrimination, eliminate barriers and restrictions, and help to improve the diversification of the portfolio. A revision of taxation rules for greater neutrality would modify the currency and geographic composition of the portfolio and reinforce the effects of other processes and factors that are acting in the same direction today, including the forex liberalization, the globalization of international financial markets, and greater integration between financial markets in Israel and markets abroad. Examination of the main aspects of the existing distortions in the taxation rules pertaining to external and forex activity, differentiated by sectors, elicits the following picture:

Resident individuals: deposits—From the tax standpoint, it is more profitable to hold nonindexed NIS deposits in Israel than to hold foreign-currency deposits, because interest earnings on the former are tax-exempt. Furthermore, interest on deposits abroad that is first received and deposited abroad is tax-exempt, whereas interest on corresponding foreign-currency deposits in Israel (apart from forex savings plans) is taxable.

Shares—Capital gains from tradable shares in Israel and Israeli industrial shares traded abroad are tax-exempt, whereas corresponding capital gains of foreign companies traded abroad are taxed at a limited rate.

The increase in the number of Israeli firms traded abroad that ‘dual-list’ themselves on the Tel Aviv Stock Exchange—including holding and nonindustrial companies, in which the holders of shares traded abroad are liable to capital-gains tax—traces largely to the capital-gains tax exemption that applies when the shares are sold on the Tel Aviv Stock Exchange.

Bonds—Capital gains from the sale of bonds traded on the TASE are tax-exempt, but a distinction is made in the sale of bonds that are traded on a foreign exchange: capital gains from the sale of bonds of foreign companies and of Israeli companies traded abroad is taxed, while capital gains from the sale of Israel Government bonds is tax-free. Individuals’ holdings of forex assets in Israel and abroad by means of mutual funds are taxed according to the rules that apply to individuals.

Israeli companies—It is preferable to keep foreign-currency deposits abroad than in Israel, because passive income that is created and produced abroad and deposited first in an account abroad is tax-exempt. (This advantage is compounded by the higher rate of return on deposits abroad, due to liquidity rules that reduce the return on foreign-currency deposits in Israel.)

Many Israeli start-up companies were prompted to register abroad, especially in the course of 2000, in view of Israel’s antiquated taxation rules concerning mergers—relative to the rules abroad—and the high rates of taxation on capital gains and sale of options.

Institutional investors—This aggregate is made up of provident and severance-pay funds, advanced-training funds, pension funds, and insurance companies. Until the end of 2001, these entities were allowed to invest 5 percent of total assets in forex-denominated assets in Israel and abroad. The pace and level of such investment were severely affected by tax distortions: the earnings (capital gains, dividends, and interest) of institutional investors, except for insurance companies, on their investments in foreign securities are taxable at 35 percent of the real value of the earnings, while the capital gains from investments in securities traded in Israel, and in most securities of Israeli firms traded abroad, are tax-exempt.

The tax rules favor insurance companies over other institutional investors: earnings (interest, dividends, and capital gains) that accrue for members of participating life-insurance plans are tax-exempt insofar as they derive from forex investments (in Israel and abroad). The absence of taxation on these earnings prompted insurance companies to step up the pace of their external investments in the second half of the year, after the restrictions on such investments were rescinded.

Deposits abroad in 2001 had an advantage of 0.3–0.5 percent in rate of return, due largely to liquidity rules pertaining to forex deposits in Israel that lowered the domestic return on such deposits. This differential had existed before, but as the market became more efficient and after an adjustment period that followed the foreign-currency deregulation, the changeover to the depositing of funds abroad gathered strength.

In a contrasting development, issuing companies reduced the balance of their deposits abroad in 2001 because the high-tech crisis stanching almost all issuing activity this year and some companies that had previously issued transferred the proceeds to Israel for domestic uses.

Israeli companies that maintained external deposit balances in excess of \$5 million must report movements in these accounts to the Bank of Israel. Analysis of the accounts, which account for 70 percent of total deposits abroad, shows \$6.6 billion in activity (receipts and payments) this year—9 percent of total activity with banks in Israel and in accounts abroad. Most activity in these accounts constituted the depositing of export proceeds (goods and services) that were received abroad. Some 7 percent of receipts of export proceeds by the nonbanking private sector this year was handled in this manner; payments for imports (goods and services), in contrast, constituted less than 1 percent of payments for imports and export receipts.

e. The foreign reserves

Israel's official foreign reserves, kept with the Bank of Israel, were unchanged this year. The most important factor behind changes in the reserves in recent years, interest rates, exerted influence in contrasting directions this year. Falling global interest rates reduced interest receipts in year-on-year comparison, but some of the decline was offset by capital gains. Notably, the year's end figure does not include grant revenues that were deferred to 2002.

Foreign reserves have been stable since 1998 and were affected, as stated, mainly by interest receipts. Until 1998, the reserves were severely volatile due to government borrowing backed by U.S. Government guarantees, which were deposited with the Bank of Israel, and due to intervention by the Bank of Israel in the NIS-forex market. Volatility has subsided since then because the Government completed its borrowing under the guarantee program, the current account has been in balance, and the Bank of Israel has not been intervening in the NIS-forex market.

The official foreign reserves, kept with the Bank of Israel, were unchanged this year.

Table 3.2.6
Foreign-Exchange Reserves of the Bank of Israel, 1999–2001

	(\$ billion)		
	1999	2000	Change in 2001
Total change	–0.2	0.7	–
Movements	1.1	0.9	–0.1
<i>of which</i> Interest	0.8	1.1	0.8
Capital gains	–1.3	–0.2	0.1

SOURCE: Reports from Ministry of Finance and Bank of Israel,