

Overview and Policy

Israel's external and foreign-exchange activity showed a contraction in the volume of balance-of-payments activity in 2002, and various developments threatened financial stability. These were the results of the cumulative negative effects on the economy of internal and external shocks, and macroeconomic policy that did not react appropriately to the deterioration in the economic situation.

The reduced volume of balance-of-payments activity on both the current account and the financial account reflected the worldwide slowdown, the slump in the high-tech industries and the crisis in international financial markets combined with the security-related events in Israel. Most of these factors also acted to increase the current-account deficit; their effect was offset by Israel's economic recession that tended to reduce imports, and by real depreciation of the NIS. As a result the current-account deficit stabilized at about 2.1 percent of GDP in 2002, similar to its level in previous years.

The crisis in international financial markets and in issues of high-tech companies led to the cessation of such offers abroad by Israeli companies, so that the sharp reduction in the inflow of long-term capital continued in 2002.

The most marked effect of the external events in 2002 on nonresidents was a fall in their direct investments in Israel. These investments, which in the past acted as a stabilizer as they were less affected by short-term considerations, declined for the first time to a level lower than in the years prior to the 'bubble' of 1999–2000. This was due to the realization that the world crisis, particularly in high-tech, was an extended one. Moreover, nonresidents assessed that the risk in investing in Israel rose in 2002, so that their special deposits in Israel went down by \$ 0.8 billion, the first time they had fallen in many years.

The total of Israelis' investment abroad fell in 2002, and its composition changed: while their direct investment remained stable and their portfolio investment actually increased, other investments fell. A notable feature was the rise in households' deposits abroad, which was due to the rise in Israel's risk assessment among other things. Since 2001 the nonbanking private sector has had a net capital outflow, and this strengthened in 2002 due to domestic developments, while the public sector and to an even greater extent the banking sector offset this with net capital inflow.

Macroeconomic policy did not react appropriately to the economic developments and external shocks, and undermined financial stability: (i) The budget was based on an assumption of renewed growth—an assumption that resulted in a rise in the deficit—and was amended in the light of the recession only in mid-2002, and even then it still involved a rise in the deficit. (ii) Based on a government undertaking to reduce the deficit, the Governor of the Bank of Israel made a surprisingly steep cut in the interest rate at the end of 2001, and when it became apparent that the government was not meeting its commitment, the Bank raised the interest rate sharply in the middle of 2002. (iii) In addition to the above there was public disagreement and a lack of coordination between the Ministry of Finance and the Bank of Israel that peaked when at the beginning of 2002 the Ministry proposed an amendment to the Bank of Israel Law without coordinating with the Bank—an amendment that would have weakened the commitment to the target of price stability and the Bank's ability to act towards its achievement.

The damage caused to 'external financial stability,' i.e., stability related to the economy's activities vis-à-vis abroad and in foreign currency, could be seen in various parameters in the NIS/foreign-exchange market and in Israel's credit risk: the NIS depreciated rapidly in the first half of the year in two stages, with a pause in March; exchange-rate risk, expressed by the implied standard deviation of NIS/dollar options, rose sharply at the end of 2001 and remained high throughout 2002; households increased their demand for foreign currency and foreign assets; Israel's credit-risk premium rose, and the international rating agencies announced their inclination to lower Israel's credit rating.

At the end of the first half of the year the Bank of Israel raised the interest rate by a cumulative 4.5 percentage points in order to prevent financial and price stability from being harmed, and the government introduced tight fiscal measures. The combined effect of these steps was marked: the NIS appreciated rapidly after its long depreciation, and inflation expectations fell. The implied standard deviation, however, indicating exchange-rate risk, remained significantly higher than at the end of 2001.

In contrast to these negative developments, there were also several positive ones in 2002: the current-account deficit did not rise, and remained at a low level relative to the GDP, and is not a burden on the economy; the net external debt continued on its downward path, mainly the short-term net debt (the short-term debt *minus* short-term assets); capital flows did not reverse and the positive investment flow into the economy continued; the NIS/foreign-currency market continued to become more efficient, particularly in the area of derivatives, and even when stability was under attack the market continued to function properly, with large turnover and a modest rise in spreads; Israel's credit rating was not lowered, despite the external and internal shocks; no direct intervention in foreign-currency trading was needed, and moderate policy steps taken with regard to the rate of interest and the budget deficit managed to stop the deterioration. These positive developments, that occurred despite the shocks, resulted from the long-term policy of liberalization and improvements of the markets.

The foreign-exchange liberalization process that began more than a decade ago was completed on 1 January 2003, when the final restriction on institutional investors was removed. This means that foreign-currency control has been completely abolished, and the NIS has become a freely convertible currency. Various provisions of the tax reform came into effect, significantly reducing the discrimination against activity abroad or in foreign currency vis-à-vis activity in Israel and in NIS, thereby contributing to the proper functioning of the financial markets. Nevertheless tax discrimination has not totally disappeared as some of the provisions of the reform relating to activity vis-à-vis abroad are being introduced gradually, over several years, and tax rates still differ between foreign-currency financial assets and those in NIS, and between insurance companies and provident funds on the one hand and other sectors on the other. Completion of the tax reform and maintaining the NIS as a freely convertible currency are cornerstones of economic policy, and increase the openness of the economy and allow it to reap the maximum benefits from integration into international financial markets and from the globalization of capital flows. These benefits derive from the contribution of foreign investment to economic growth and from the contribution of foreign financial institutions to the integrity, streamlining and stabilization of the financial system and the financial markets, as well as from the public's ability to diversify its assets and liabilities portfolios and to readily adjust their composition to changing conditions.

The argument is occasionally heard for restricting the economy's financial openness, despite its many advantages, on the grounds that it makes the economy more vulnerable. Although reducing the openness of the economy might indeed lower its vulnerability to external financial shocks, reimposing control is an inappropriate policy for several reasons: first, openness is essential for the economy in the era of the global economy and international standards. Second, taking a comprehensive view, openness contributes to economic stability by helping the economy and the financial markets to develop, whereas a closed economy creates artificial stability that increases the intensity of the harm caused by shocks. Third, experience shows that most financial crises occur in fixed-exchange-rate regimes that tried to implement rapid liberalization programs that were unsuitable for the existing economic situation; in Israel, on the other hand, the process of liberalization took place over the last decade as the exchange-rate regime became more flexible and openness was achieved gradually, in accordance with the economic situation and the financial system. Finally, experience has shown that long-term control restrictions are inefficient and their operation is very costly.

The openness of the economy, its sensitivity to external shocks, and its constant scrutiny by nonresidents drive home the importance of a well-considered, cautious and consistent macroeconomic policy. One component of such a policy is the preservation of financial stability. External financial stability requires constant improvement of the NIS/foreign-currency market on the one hand, and diligent monitoring and analysis of activity in it on the other.

The NIS/foreign-currency market is the most liquid and the deepest of Israel's financial markets. Over the last ten years it has undergone a gradual process of improving efficiency and deepening. This was due to the liberalization of foreign-currency control, the greater flexibility introduced into the exchange-rate regime, the improvement of trading arrangements, and in the last few years also the activities of foreign financial institutions in the market. Since the beginning of 1998 the market has functioned properly without the Bank of Israel having to intervene in trading even when the market was experiencing shocks, indicating that the market has a suitable infrastructure that enables the completion of the process of making the exchange-rate regime more flexible.

Over the last ten years the exchange-rate band widened. It continues to do so as an intrinsic component of the regime, but nevertheless still limits the area in which the exchange rate can fluctuate; it can thus have a negative effect on market players when the exchange rate approaches one of the limits of the band, as the Bank of Israel is committed to intervening in trading to protect the limits. Abolishing the exchange-rate band regime and switching to a floating exchange rate will allow full use to be made of the exchange rate as a shock-absorber mechanism. For this reason, and against the background of globalization and increased worldwide capital flows, the number of countries that have adopted floating-exchange-rate regimes has grown, and the number of those operating fixed exchange rates has shrunk.

Managing a policy of maintaining stability necessitates the study of the conditions for market stability, past experience, the factors that cause and exacerbate the damage, and the processes that undermine stability. Constant monitoring is required so that these processes can be identified as early as possible, distinguishing between transient negative developments and the start of a process that could undermine stability. The analysis of market activity by sector and the monitoring of changes in sectoral activity are of paramount importance to enable the behavioral patterns of the different sectors in periods of calm and of crisis to be identified, primarily those of the large financial market players and of households. Such analysis and monitoring are based on comprehensive, detailed and up-to-date information. Over the last few years, as liberalization proceeded, the Foreign Exchange Activity Department (formerly the Foreign Exchange Control Department) established information systems that consolidate comprehensive and detailed data on economic activity vis-à-vis abroad and in foreign currency. These systems make it possible to carry out the ongoing analysis of the data needed for purposes of monetary policy, for monitoring market stability and for identifying trouble spots and processes that could undermine stability. The department processes the information gathered and regularly publishes the results with minimal delay, with the intention of improving the quality and accessibility of information available to the players in the financial markets. This derives from the awareness of the fact that transparency of markets contributes to their integrity, thereby enhancing their stability.

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OVERVIEW AND POLICY

This report has two sections. The first deals with Israel's economic activity vis-à-vis abroad: with activity in the balance of payment current account and financial account, with Israel's international investment position (IIP), and with the external debt and the economy's credit risk. The second section discusses activity in the NIS/foreign-currency market: the activity—with nonresidents and between the sectors—of residents in the different sectors in assets and liabilities in or indexed to foreign currency, and the activity of nonresidents in local-currency assets and liabilities (including NIS/foreign-currency futures).

The data in this report derive mainly from reports to the Foreign Exchange Activity Department from the banks, companies, institutional investors and individuals. Other sources of information used in this report are reports submitted to other Bank of Israel departments, data of the Accountant General in the Ministry of Finance on government activity, Stock Exchange Authority data, and current-account data of the Central Bureau of Statistics.