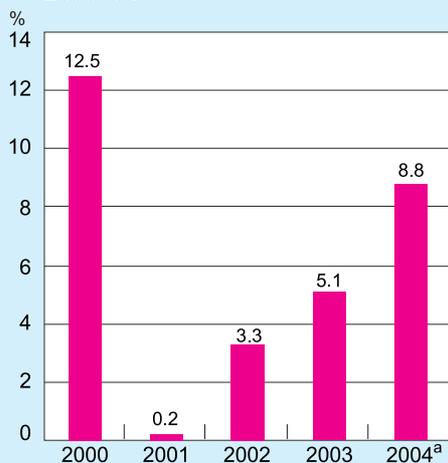


Chapter 1

Main Developments

In 2004, as in 2003, the current account ended the year with a \$ 0.5 billion surplus after deficits since the early 1990s (Table 1.1.1).¹ The improvement in the past two years is especially conspicuous in view of the economic growth that occurred during this time; in the past, growth had been accompanied by current-account deficits. The positive level of the current account, coupled with price and exchange-rate stability, have made the opening conditions for 2005 among the best that the economy has ever known.

Figure 1.1.1
Annual Growth of World Trade,
2000–04



^a Estimate.

SOURCE: World Economic Outlook, IMF, November 2004.

The current-account improvement in 2004 coincided with an 18 percent expansion of activity on goods and services account of the balance of payments, surpassing the 2000 level. The goods account grew more vigorously than the services account. These growth performances were abetted by the continued global economic recovery but outperformed the recovery by a wide margin (Figure 1.1.1). The financial account also expanded for the second straight year. Foreign investment was \$ 6.6 billion as against \$ 6 billion in 2003 and resident investment (net of the change in foreign reserves) increased to \$ 9.2 billion as against \$ 6.1 billion a year earlier. In foreign investment, issues

by technology companies on foreign exchanges increased perceptibly and direct investment declined significantly. In resident external investment, the increase in external deposits of the banking system stood out.

¹ This chapter does not discuss the macroeconomic aspects of the current account; this matter is discussed at length in the portion of this Report written by the Research Department.

Table 1.1.1
Israel's Balance of Payments, 2000–2004

	(\$ million)				
	2000	2001	2002	2003	2004
1. Net goods, services, and factor inputs (a+b+c)	-8,026	-8,612	-8,306	-5,794	-5,695
a. Net goods	-2,857	-3,036	-3,684	-2,234	-2,397
Exports	31,188	27,967	27,535	30,098	36,167
Imports	-34,045	-31,003	-31,219	-32,332	-38,564
b. Net services	2,033	-642	-513	312	725
Exports	14,539	11,784	10,982	12,266	14,209
Imports	-12,506	-12,427	-11,494	-11,954	-13,484
<i>Of which:</i> Tourism	1,270	-482	-503	-511	-413
Revenues	4,074	2,463	2,039	2,039	2,383
Expenditures	-2,804	-2,945	-2,543	-2,550	-2,796
Other services	3,598	2,615	2,607	3,372	4,048
c. Factor revenues	-7,202	-4,933	-4,109	-3,873	-4,022
1. Net interest and dividends	-3,985	-1,999	-1,566	-1,655	-2,028
2. Net wages	-3,217	-2,934	-2,543	-2,217	-1,994
<i>Of which:</i> Wages of foreign workers	-2,283	-2,579	-2,343	-1,956	-1,751
Wages of Palestinian workers	-979	-400	-232	-282	-275
2. Net current transfers	6,483	6,692	6,762	6,372	6,199
3. Current account (1 + 2 = 3)	-1,543	-1,920	-1,544	578	504
4. Capital account and financial account	2,831	1,621	-539	-1,066	-2,460
a. Capital account	455	679	151	465	523
b. Financial account (excl. net reserve assets) ^a	3,268	804	-1,312	-217	-2,669
1. Direct investments	1,740	2,947	788	1,812	-1,418
2. Portfolio investments	2,234	-1,548	-1,985	-812	3,877
3. Other investments	-1,369	-1,104	-308	-1,556	-5,612
4. Financial derivatives	663	510	193	339	483
By sectors					
1. Nonbanking private sector	3,381	501	-2,268	336	520
2. Banks	53	1,281	703	-2,548	-4,530
3. Public sector	-166	-979	252	1,996	1,341
c. Net reserve assets ^a	-892	138	623	-1,314	-314
5. Statistical discrepancies (-4 -3 = 5)	-1,288	299	2,083	488	1,956
6. Current-account deficit as share of GDP (percent)	-1.3	-1.7	-1.5	0.5	0.4

^a Capital inflows and increases in liabilities are marked with a positive sign (+); decreases in liabilities and increases in assets are marked with a negative sign (-); increases in reserve assets are marked with a negative sign (-).

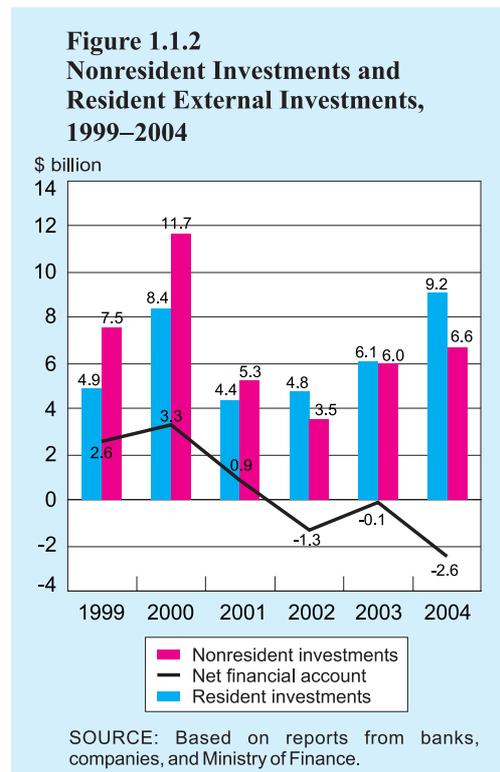
SOURCE: Based on Central Bureau of Statistics data.

The increase in exports of goods and services contributed to the upturn in imports because some imports serve as intermediates for exports. The expansion of imports in 2004 was also related to the increase in domestic demand. All types of imports (raw materials, consumption goods, and capital goods) increased, as opposed to the trend in 2003, when the economic slowdown held the increase in imports to a negligible rate while exports rose twice as rapidly. Notably, the rate of increase in exports of goods and services in the past two years surpassed that of domestic growth by far. As a result, the deficit on account of these two forms of activity fell to half its level in the preceding two years. It was this expansion that made a contribution to the change in the current account.

Much of the increase in current-account activity during the past two years traces to high-tech industries, which account for nearly half of industrial exports, and software and R&D services, the exports of which are recorded in the services account. These industries together exported \$ 15 billion in 2004. The regional geopolitical improvement in 2004 boosted inbound tourism by 40 percent. However, tourist arrivals remained 38 percent under the 2000 level and tourism revenue fell short of the 2000 level by \$ 1.6 billion than in 2000.

The upturn in global interest rates in the second half of the year was reflected in the factor- income account, raising the net interest income of the private sector (banking and nonbanking), whose external assets increased by \$ 8 billion. The change in interest rates had hardly any effect on general-government expenditure because almost all general-government liabilities are long-term and at fixed interest rates. The wage-expenditure component has improved considerably in recent years because the population of foreign and Palestinian workers has declined. Since its peak in 2001, wage expenditure for foreign workers has fallen by \$ 0.8 billion and that for labor from the Palestinian Authority areas by \$ 0.7 billion, with the combined expenditure on both totaling \$ 1.5 billion.

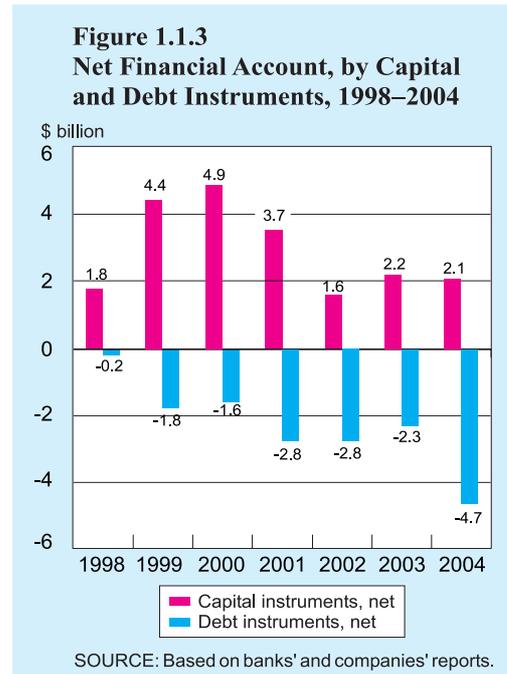
The net financial account (foreign investment less resident external investment except for reserve assets), which had run a surplus for many years, recorded its first deficit in 2002, the crisis year, and the deficit increased to \$ 2.6 billion this year (Figure 1.1.2).



Turning to the distinction between capital instruments and debt instruments in the net financial account, the economy has had a surplus of capital instruments in all recent years. Thus, foreign investment in shares (direct and portfolio), a reflection of foreign investors' confidence in Israel, exceeds resident investments in these instruments abroad. In debt instruments (bonds, credit, and deposits), in contrast, the domestic economy is in deficit. This is a consequence of the surplus in capital instruments, since the typical level of the current account ranges from balance to a small surplus.

The capital-instrument surplus declined from \$ 4.3 billion in 1999–2001 to \$ 2.2 billion in 2003 and 2004 (annual averages in both periods) as resident external investment expanded more quickly than foreign investment,

and not due to a decline in Israel's attractiveness to foreign investors. Indeed, all factors that tend to attract foreign investment—the growth rate, technological innovation—which had an upward effect on investments in these industries (see box in the chapter on foreign investment)—the geopolitical situation, confidence in economic policy, greater efficiency in the capital markets, privatization, and the deregulation process—have shown signs of improvement in the past two years. However, the factors that encouraged residents to invest in foreign capital instruments were more intensive. Important factors of this type include the globalization process in which large Israeli firms are participating, reflected among other things in rather large acquisitions of production lines abroad, and the high-tech recovery, which has caused investments in these industries to rise. The net



debt-instrument deficit climbed from \$ 2.6 billion on average per year in 2001–2003 to \$ 4.7 billion in 2004, largely due to an increase in the surplus of sources of the banking system, which the system invests abroad; the lowering of the liquidity ratio on commercial banks' deposits with the Bank of Israel; a decline in demand for forex credit, and the tax reform, all of which made foreign assets relatively more profitable for households and institutional investors to hold.

In response to the factors that abetted change in the net financial account, the banking system, which operates mainly by means of debt instruments, transferred \$ 7.3 billion (cumulative terms) in other sectors' excess forex sources out of the country in the past

two years, including \$ 2.7 billion in the last quarter of 2004. In contrast, the private sector and general government had surpluses (Table 1.1.1).

Net direct investment flows turned around in 2004 and became negative for the first time in many years as foreign investment declined steeply and net portfolio investment became positive after three years of decline, largely due to an increase in Israeli high-tech issues on foreign exchanges (Figure 1.4). Some of the change traces to one large transaction that was recorded both as an increase in foreign portfolio investment and an increase in direct resident investment abroad.

Foreign investment: In 2004, Israel maintained its share in the total capital inflow to emerging-market economies but the composition of the total, in terms of types of investments, changed sharply relative to these economies. As stated, direct investment declined steeply, from \$ 4 billion in 2003 to only \$ 1.6 billion in 2004, whereas portfolio investments climbed from \$ 2 billion to \$ 5.4 billion in the respective years (Table 1.1.2). The decrease in direct investment occurred despite the upturn in mergers and acquisitions around the globe and the improvement in Israel's macroeconomic fundamentals. However, it originated in the timing of a small number of large investment transactions and a technical shift from the direct-investment line to the portfolio-investment line, as opposed to a decrease in Israel's attractiveness to foreign investors. For example, nonresidents realized a \$ 0.7 billion direct investment in a telecommunications company due to privatization processes in this industry that matured during the year. In the fourth quarter of 2004 and in early 2005, agreements were concluded for the performance of \$ 1.9 billion in direct investments that will largely be reflected in the 2005 data, which are expected to show a large increase relative to the long-term average. Foreign direct investors in Israeli high-tech shares abroad sold \$ 0.5 billion of their holdings to foreign portfolio investors in view of the relatively high prices that Israeli technology shares were commanding. Furthermore, capital raising by VC funds and investments in start-up companies, which reflect nonresidents' confidence in Israeli technology, increased vigorously even in American terms. The recovery of real global demand for high-tech products was accompanied in 2004, in contrast to 2003, by an upturn in international capital issues and led, as stated, to a rapid increase in Israeli technology share issues on American exchanges, at \$ 2.8 billion as against \$ 1 billion in 2003—a rate exceeding the upturn in issuing by domestic companies. In all, \$ 5 billion was invested in shares (directly and for the portfolio) in 2004, the highest level in the past four years.

The global uptrend in investments in emerging markets' stock exchanges in 2004, occasioned by poor yields on risk-free assets in developed countries and the decline in the riskiness of the emerging markets, was also evident on the Tel Aviv Stock Exchange and prompted nonresidents to invest \$ 0.5 billion in shares, mostly in the fourth quarter of the year, as against negligible investment in the bond market. Nonresident activity in government bonds is expected to increase in 2005 as several reforms in this market go into effect.

Resident investment: The worldwide high-tech recovery and the continued integration of Israeli firms into the globalization process acted to sustain the upturn in the direct investment flows of Israeli firms abroad and encouraged two changes in the patterns of investment—from the acquisition of marketing channels to the acquisition

Table 1.1.2
Israel's Assets and Liabilities vis-à-vis the Rest of the World

	(\$ millions)					
	2003		Change	Exchange-rate	Other	2004
	balance	Movements	in prices	differentials	adjustments	balance
A. Assets						
1. Total national assets	88,364	9,557	234	1,117	692	99,964
Thereof: debt instruments (2.3+3.2+4+5)	77,262	7,178	-13	1,056	17	85,500
2. Direct external investment	13,063	3,039		61	-154	16,010
2.1 Share equity	7,987	2,228		61	-30	10,247
2.2 Real estate	-	-6			6	
2.3 Equity holders' loans	5,076	817			-130	5,763
3. Portfolio investment	13,750	1,527	247	133	318	15,976
3.1 Share equity	3,115	641	247		215	4,218
3.2 Bonds	10,635	886		133	103	11,758
4. Other external investments	34,325	5,431		440	83	40,280
4.1 Resident deposits	10,885	1,048			83	12,016
4.2 Deposits of Israeli banks	9,877	4,262		279		14,418
4.3 Loans	5,941	-316		71		5,696
4.4 Customer credit	7,622	438		89		8,149
5. External assets of general govt.	27,226	43	-13	482	-39	27,699
Thereof: foreign reserves	25,788	382	-13	474		26,632
6. Derivatives		-484			484	-
B. Liabilities						
1. Total national liabilities	123,505	6,644	3,880	845	224	135,097
Thereof: debt instruments (2.3+3.2+4)	71,177	1,664		792		73,633
2. Direct investment	31,660	1,617	815	20	-957	33,156
2.1 Share equity	29,320	684	815	9	-149	30,679
2.2 Real estate	-	808			-808	..
2.3 Equity holders' loans	2,340	125		11		2,477
3. Portfolio investments	43,312	5,391	3,065	164	1,181	53,113
3.1 Share equity	23,008	3,488	3,065	44	1,181	30,785
3.2 Bonds	20,304	1,903		120		22,328
4. Other investments	48,532	-364		661		48,829
4.1 Nonresident deposits	21,356	-457		345		21,244
4.2 Deposits of foreign banks	3,389	-638		19		2,770
4.3 Loans	17,875	606		216		18,697
4.4 Suppliers' credit	5,912	126		80		6,118
C. Net liabilities (B1 less A1)	35,140	-2,913	3,646	-271	-468	35,133
Thereof: net debt instruments	-6,058	-5,514	13	-263	-17	-11,867

SOURCE: reports from banks, corporations, government offices, and Securities Authority, processed by the Foreign Exchange Activity Department.

of production lines and from financing by means of loans to financing by equity investment. Investment flows in the portfolio assets of households and institutional investors slowed in the second half of the year, mainly due to the appreciation of the NIS and a decline in the prices of foreign assets, even though the January 2005 tax reform will make it relatively more profitable to hold assets abroad. (See box in the NIS–Forex Market section.) The business sector expanded its external depositing vigorously due to increases in exports and external issues and as hedging for the innovative financial instruments that financial companies in this sector issued to residents in 2004. As stated, the banking sector deposited much more money abroad than before, as the narrowing of the NIS-forex interest spread created surpluses of forex sources.

Balance of Payments and External Debt

In the balance of payments (BOP), the movements of the domestic economy vis-à-vis the rest of the world are recorded in three accounts: current, capital, and financial. The difference between the current account and the capital and financial accounts is expressed in the form of statistical differentials, the size of which reflects measuring errors in all BOP components. In the past four years, statistical differentials have become positive but very volatile, ranging from \$ 0.3 billion to \$ 2.1 billion per year, making developments hard to analyze (Table 1.1.1). Positive statistical differentials may indicate that the current-account data are higher than what was measured (i.e., in years of current-account deficit, the deficit was smaller than the measured level and in years of surplus it was larger) or that additional unidentified money flows entered the economy. Various indications show that the former factor has been dominant in recent years and that the export data and, therefore, the current-account data are evidently skewed downward.

The deficit on goods, services, and factor-income account (the current-account deficit net of current transfers—hereinafter, “the deficit”) shows the surplus of imports over exports in economic activity vis-à-vis the rest of the world in these fields. The deficit in 2004, \$ 5.7 billion, was almost identical to that in the previous year (Table 1.1.3). To calculate the size of the deficit that has to be financed and to compare it with the sources of finance available to the economy, one should subtract the statistical differentials from the deficit because they represent measuring errors in the current and financial accounts. The result obtained is the deficit in need of financing, i.e., the financing needs of the deficit. Since the statistical differentials have been positive for the past three years, these needs were smaller than the deficit. In 2004, the statistical differentials surpassed those of the previous year by \$ 1.5 billion; as a result, the financing needs of the deficit were \$ 3.7 billion—\$ 1.6 billion less than in the previous year (Table 1.1.3).

To cover the deficit in need of financing, the economy may use debt and non-debt sources—current transfers, capital transfers, and investments in capital instruments.

In recent years, the deficit was financed by means of non-debt sources, the largest component of which was current transfers. Total non-debt sources in 2004 resembled the 2003 level, and this year, as in the previous two years, current and capital transfers met all the financing needs of the deficit with room to spare. The surplus of sources from transfers and investments increased by \$ 1.6 billion in 2004 and came to \$ 5.6 billion, allowing the economy to reduce its net external debt.

The process of reducing the debt as a result of surplus sources began in 1998 and gathered momentum in the last three years. It reflects developments in the financial account—that have left the economy with a surplus of capital instruments and a deficit of debt instruments—as well as the reduction in the deficit. In the same period nonresidents' direct investment and portfolio investment exceeded those of residents. Concurrently, current transfers and capital transfers led to surplus sources due to

Table 1.1.3
Balance of Payments and Net External Debt, 2000–04

	(\$ million)				
	2000	2001	2002	2003	2004
1. Deficit on goods, services, and factor inputs account	-8,026	-8,612	-8,306	-5,794	-5,695
1.1 Goods account	-2,857	-3,036	-3,684	-2,234	-2,397
1.2 Services account	2,033	-642	-513	312	725
1.3 Factor input revenues	-7,202	-4,933	-4,109	-3,873	-4,022
2. Statistical differentials (1-4 + 6 = 2) ^a	-1,288	299	2,083	488	1,956
3. Financing needed (1 + 2 = 3)	9,314	8,313	6,223	5,306	3,739
4. Total financing sources (4.1 + 4.2 = 4)	10,206	8,175	5,600	6,620	4,053
4.1 Transfers and investment	12,463	11,542	8,672	9,252	9,327
4.1.1 Net current transfers	6,483	6,692	6,762	6,372	6,199
4.1.2 Capital transfers	455	679	151	465	523
4.1.3 Direct and equity investment	5,524	4,172	1,759	2,415	2,605
Nonresident investment	8,978	4,094	2,196	4,101	4,984
Resident external investment	-3,454	77	-437	-1,686	-2,379
4.2 Net formation of debt ^b (loans ^c and deposits)	-2,256	-3,368	-3,072	-2,632	-5,273
Private sector	-2,090	-2,389	-3,323	-4,628	-6,614
Public sector	-166	-979	252	1,996	1,341
5. Surplus of sources from transfers and investment (4.1-3=5)	3,148	3,229	2,449	3,946	5,588
5.1 Derived change in net external debt (=6-4.2)	-3,148	-3,229	-2,449	-3,946	-5,588
6. Surplus financing = increase in foreign reserves ^b (4-3=6) (4.2+5=6)	892	-138	-623	1,314	314
7. Exchange-rate differentials, capital gains and adjustments to net external debt	-369	42	-31	33	-462
8. Implicit change in net external debt ^b (5+7=8)	-3,517	-3,187	-2,480	-3,913	-6,050
9. Net external debt (end of year)	3,730	543	-1,936	-5,849	-11,899

^a To calculate the need for financing, statistical differentials are subtracted from the deficit because they reflect measuring errors in the goods, services, and factor input account and in capital flows. Evidently the level of the deficit was different from the measured result and the economy had financing sources that were not identified.

^b Excluding exchange-rate differentials and capital gains.

^c Credit and bonds.

SOURCE: Based on Central Bureau of Statistics data and processing by Bank of Israel.

the reduction in the deficit and its financing requirements. The surplus from the two sources (investments in capital instruments and transfers) were invested abroad in debt instruments, so that in the last few years there was a deficit of debt instruments on the financial account, meaning an increase in Israel's net balance of debt assets abroad. This reflects a balanced division of risks between Israel and abroad, since capital instruments, of which Israel has a surplus, have a higher risk than debt instruments, of which Israel has a deficit. The sources created by relatively risky investment by nonresidents are therefore invested in channels with low financial risk.

The entire increase in the net debt-asset surplus is imputed to the private sector—banking and nonbanking—which, due to a \$ 6.6 billion surplus of sources over financing needs, built up its external asset surplus by this sum. The government, in contrast, increased its net external debt by \$ 1.3 billion during the year, mostly due to bond issues and the U.S. guarantee arrangement, and the foreign reserves increased by \$ 0.3 billion. For these reasons, the net external debt assets balance (the surplus of debt instrument assets over external debt) increased by \$ 6 billion in 2004 and stood at \$ 12 billion at year's end (including the effect of exchange-rate differentials, capital gains, and other adjustments).