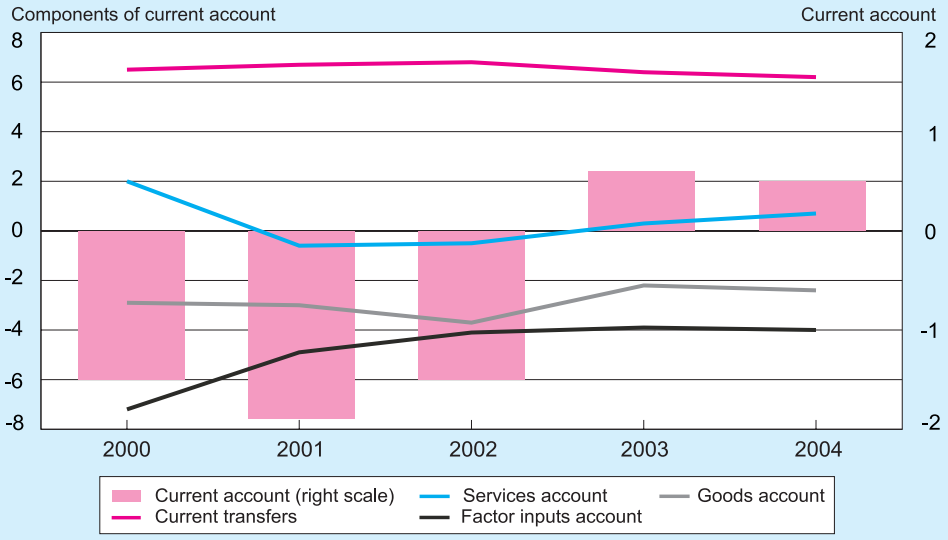
Chapter 2
Current Account and Capital Account[1]

1.MAIN DEVELOPMENTS

In 2004, as in 2003, the current account ran a $ 0.5 billion surplus after deficits since the early 1990s (Table 1.1.1 and Figure 1.2.1). The improvement was powered by the private sector, which recorded its first surplus (Table 1.2.1) but the current-account surplus of general government continued to contract as well (Table 1.2.2). As the balance of payments improved, activity on goods and services account expanded by 18 percent—20 percent on goods account and 12 percent on services account—and surpassed the 2000 level.

The current account ended the year with a $ 0.5 billion surplus. The private sector had a surplus for the first time.
Activity in the goods and services account expanded by 18 percent.

Figure 1.2.1
The Current Account and its Components, 2000–04 ($ billion)

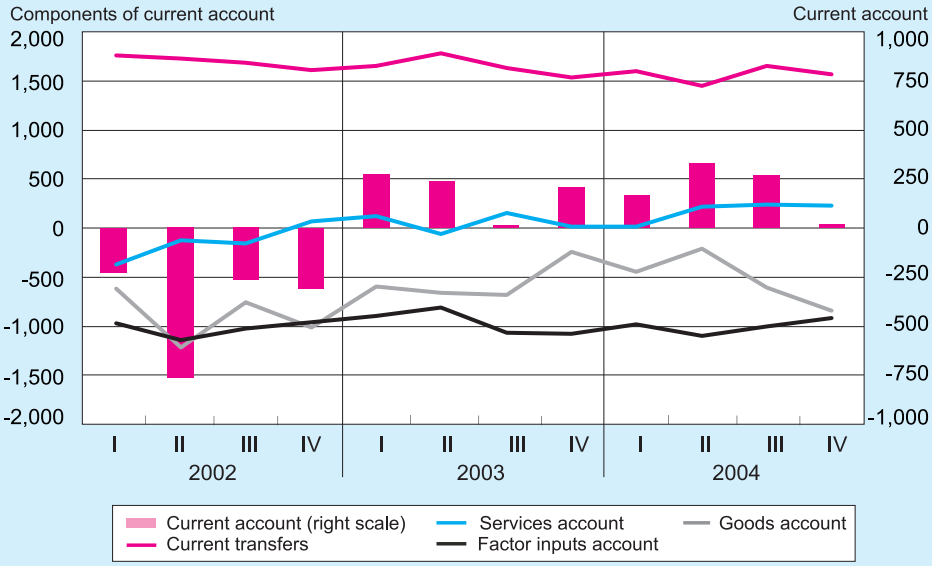


SOURCE: Central Bureau of Statistics.

Seasonally adjusted data show a continued uptrend in the current account during the first three quarters of the year that stopped in the fourth quarter (Figure 1.2.2).

[1] This chapter does not discuss the macroeconomic aspects of the current account; in that regard, see lengthy discussion in the Research Department survey.

Figure 1.2.2
The Current Account and its Components, 2002–04
(quarterly, seasonally adjusted, $ million)



SOURCE: Central Bureau of Statistics.

Developments during the year point to a difference in trend between the components of the current account in each of the two halves of the year. The goods account improved in the first half and worsened in the second half, as a vigorous increase in imports more than offset the entire improvement that occurred during the first half. On services account, in contrast, the improvement began in the second quarter and continued in the second half of the year. During the second half, the revenues account improved, as did the current-transfers account after two years of gentle downtrend.

The current-account improvement was influenced mainly by international developments.

The largest contribution to the current-account improvement this year appeared on the "Other Services" line—in which exports of computer and R&D services figure importantly—with a $ 0.7 billion increase in net revenues in 2004. Net current transfers to the private sector also increased by an appreciable $ 0.4 billion, due to an upturn in nonrecurrent restitution payments to Holocaust survivors and an increase in institutional transfers. Most of this increase, however, was offset by a decline in grants-in-aid from the US Government.

The current-account improvement that began in 2004 was influenced mainly by international developments that more than offset domestic developments, which, in turn, contributed to the increase in imports:

a. The global economic recovery, manifested in an expansion of global trade, affected growth in exports of goods and services. Notably, Israel's rate of increase was more than twice that of the expansion of global trade.

b. The expansion of goods and services exports was also abetted by the real currency depreciation that began in 2001.

Table 1.2.1
Current Account of Private Sector, 2000–2004

($ million)

	2000	2001	2002	2003	2004
1. Net goods, services and factor inputs	–5,233	–5,591	–4,907	–2,515	–2,367
Net goods	–921	–890	–1,273	–179	–502
Exports	31,188	27,967	27,535	30,098	36,167
Imports	–32,109	–28,856	–28,808	–30,278	–36,668
Net services	2,154	–476	–329	503	912
Factor input revenues	–6,466	–4,226	–3,305	–2,839	–2,777
2. Net current transfers	2,131	2,383	2,362	2,296	2,730
3. Net current account (1+2)	–3,102	–3,208	–2,545	–218	363

SOURCE: Based on data from Central Bureau of Statistics.

Table 1.2.2
Current Account of Public Sector, 2000–2004

($ million)

	2000	2001	2002	2003	2004
1. Net goods, services and factor inputs	–2,793	–3,021	–3,399	–3,280	–3,327
Of which: Government	–3,842	–4,008	–4,191	–3,851	–3,845
a. Net goods (defense imports)	–1,936	–2,146	–2,411	–2,054	–1,895
b. Net sevices (government)	–121	–167	–184	–191	–187
c. Factor input revenues	–736	–707	–804	–1,034	–1,245
Government	–1,785	–1,694	–1,597	–1,605	–1,763
Of which: Accrued interest	–490	–432	–539	–377	–621
Bank of Israel	1,049	987	792	571	518
2. Net current transfers	4,352	4,309	4,400	4,075	3,469
Government	3,433	3,582	3,615	3,309	2,564
National and government institutions	919	727	785	766	904
3. Net current account (1+2)	1,559	1,288	1,001	796	141
Of which: Government	–409	–426	–576	–542	–1,281
Government excl. accrued interest	80	6	–37	–165	–660

SOURCE: Based on data from Central Bureau of Statistics.

c. The depreciation of the euro, most of which occurred in the last quarter of the year, had little direct effect on the balance of payments. Current transfers on restitution account (in dollar terms) increased but so did the deficit on goods account with Europe.
d. The increase in short-term global interest rates had little effect. It increased the revenues of the private sector but had no effect on general-government expenditure, since almost all of the government debt was amassed at fixed interest rates and lengthy terms.

The real depreciation trend that began in 2001 continued.

The real exchange rate makes it possible to assess the competitiveness of domestic producers (in goods and service industries) with external competitors. Therefore, it is one of the variables that best explain trade-balance trends. The real exchange rate may be measured in several ways (see box). According to most indicators, the real exchange rate of the NIS is higher today than it was during all of the past decade, due to a lengthy process of real depreciation that began in 2001. This process, hastened by

nominal depreciation in 2002, continued in the two following years even though the nominal indicators of the exchange rate leveled off. This real depreciation seems to have acted in support of the improvement on goods and services account in the past two years.

During the past two years, exports of goods and services grew more rapidly than imports. Consequently, the deficit on these two lines has contracted to less than half of its level in the previous two years. The expansion accounts for most of the change in the current account from deficit to surplus in 2003 and 2004. However, there is a conspicuous difference between the years. In 2003, the economic slump led to a contraction of imports of consumer goods and abetted the slowdown in imports for domestic manufacturing. Net imports of goods, excluding ships, aircraft, diamonds, and energy, increased by 0.6 percent that year, whereas net exports of goods, excluding ships, aircraft, and diamonds, expanded by 7.1 percent. Thus, the deficit on goods account contracted by $ 1 billion. In 2004, a year of growth, imports of all types expanded in volumes and at rates that resembled the growth of exports (a 20.5 percent increase in imports and a 21.9 percent increase in exports, according to the foregoing definitions). Therefore, in 2004 the contribution to the current-account improvement was positive only on services account, in which exports grew faster than imports.

High-tech industries, which account for nearly half of industrial exports, and software and R&D services, the exports of which are recorded on services account, accounted for much of the increase in the volume of current-account activity in 2004. Exports on these two lines in 2004 came to $ 15 billion. Since exports and imports are interrelated in the sense that imports are an input for exports, an increase in exports entails an increase in imports. The share of imports is high, for example, in the diamond industry and in several high-tech industries and smaller in software and R&D, so that software and R&D exports make a larger contribution to the current account.

The expansion of imports was also related to the increase in domestic demand in 2004. Here the import component has an upward effect on the current-account deficit. In this context, however, it should be noted that since the increase in exports of goods and services was much more vigorous than domestic growth in the past two years, it offset the increase in imports. Consequently, the expansion of exports at a higher rate than domestic growth carries the potential for continued improvement in the goods and services account.

The decrease in wage expenditure for foreign workers, continuing since 2000, also made a strong positive contribution to the current account. The decrease traces to two factors. First, the policy of reducing the population of foreign workers has brought the numbers of such workers down without generating significant upward pressure on the wages of those who have remained. Second, the population of workers from the Palestinian Authority areas has plummeted in recent years due to the security events. For these reasons, wage expenditure for foreign workers has fallen by $ 0.8 billion from its 2001 peak and expenditure for workers from the PA areas has slipped since 2000 by $ 0.7 billion—$ 1.5 billion combined.

The deficit on goods, services, and factor-inputs account was financed by direct transfers.

The deficit in need of financing[2] is covered mainly by current and capital transfers. In recent years, the economy has been enjoying a surplus of nondebt sources—transfers and net investments in capital instruments—and since 2002 the current transfers have sufficed to meet all deficit-financing needs. The surplus of sources has allowed the economy to continue building up its net surplus of debt assets, i.e., to be a net lender to the rest of the world. The debt-asset surplus climbed to $ 12 billion at the end of 2004 (for discussion of how the deficit is financed, see Chapter 1).

Box 1.2.1
The Real Exchange Rate—Indicators of External Economic Competitiveness

The real exchange rate is considered an important parameter in determining the competitiveness of the tradable sector of an economy vis-à-vis its trading partners. By definition, real exchange rate is equal to the relative price of external goods and services in terms of domestic products. The higher the real exchange rate is, the less expensive domestic products are and, therefore, the easier it is for domestic manufacturers to compete with those abroad. This should lead to an increase in exports, a decline in imports, and an improvement in the balance of trade. However, there is no consensus about how to define and measure this price ratio. The IMF, for example, publishes three separate indicators of the real exchange rate for each industrialized country; sometimes the indicators for one country have a very low, or even negative, correlation. The literature[1] presents several accepted ways to measure the ratio[2]:

a. **Calculation of the price ratio using the external and domestic Consumer Price Indices** in order to yield an indicator of the external purchasing power of the domestic currency. This method, however, is popular not because it is preferable to others but mainly because consumer price indices are available at high frequency in all countries.

[1] See, for example, Marsh, I. W., and Tokarick, S. P. (1994), "Competitiveness Indicators: A Theoretical and Empirical Assessment," IMF Working Paper WP/94/29. The chapter Output and the Principal Industries in the Research Department volume of the Bank of Israel Annual Report 2004 uses other indicators for the real exchange rate. These indicators describe the rate as the ratio of export and import prices to domestic product prices.

[2] When an external price level is expressed in foreign exchange while the domestic price level is expressed in NIS, this price ratio should be multiplied by the exchange rate of the foreign currency in which the external prices are denominated, in order to align the two price levels in identical currency terms.

[2] The deficit on goods, services, and factor-imports account, less statistical differentials that reflect measurement errors the current and financial accounts.

b. **Calculating the price ratio on the basis of external and domestic unit labor cost.** Unit labor cost is defined as labor wage per given unit of time divided by output per worker during the same unit of time. This indicator reflects the competitiveness of the domestic economy in terms of the structure of manufacturing costs, since a decline in the domestic wage or an increase in domestic labor productivity makes domestic manufacturers more competitive of vis-à-vis external rivals and is reflected in the index as real depreciation.

c. **Calculating the ratio of the external export price index to the domestic export price index.** This approach presumes that each economy specializes in manufacturing (and exporting) a certain product that is an imperfect substitute for external products. An increase in external export prices relative to domestic export prices makes domestic manufacturers more competitive.

d. **Calculating the ratio of the prices of domestic tradable goods to those of domestic nontradable goods.** A relative increase in the prices of tradable goods will prompt manufacturers to make produce of these goods and induce consumers to buy less. The resulting surplus supply of tradable goods leads to an increase in exports and a decrease in imports. According to the Balassa-Samuelson theorem, an improvement in productivity causes appreciation in the real exchange rate measured by this indicator.

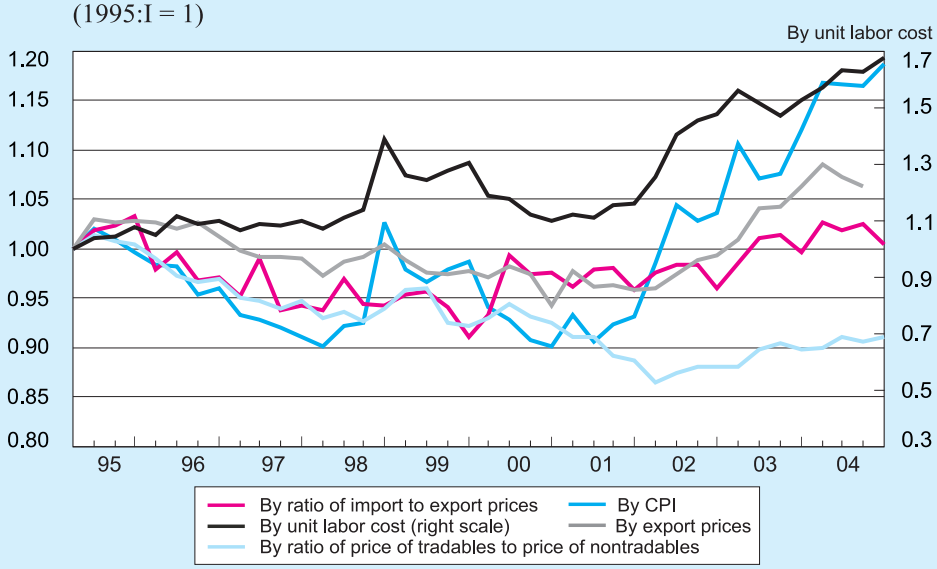
e. **Dividing the import price index by the export price index**. This approach uses domestic import prices as an index for the weighted price of imported goods. The relationship between this index and the trade balance is almost counterintuitive due to the conventional belief that the current account improves if the price of an export product rises relative to that of an imported product (an "improvement in terms of trade"). This approach, however, rests on the premise that a domestic export product is a substitute for an imported product. Therefore, a decrease in its relative price boosts **external demand** for the domestic export and lowers **domestic demand** for the imported product.

In regard to the first three indicators, a distinction should be made between the **bilateral** exchange rate and the **effective** rate. For example, we obtain Israel's real **bilateral** exchange rate against the US dollar by multiplying the nominal dollar exchange rate by the ratio of the American and Israeli consumer price indices. However, if we want the results to reflect the price levels of all of Israel's economic rivals, we must adopt a method that will weight the exchange rates and price levels of each of the trading partners.

To accomplish this, we adopted the conventional approach of the IMF[3] and the Federal Reserve, which weights each country's share in the index as a weighted average of the weight of each country in the domestic economy's (Israel's) imports, the weight of the same country in Israel's exports, and a multilateral export factor that takes into account competition between Israeli exporters and those of said country in third markets. This means that if a given competing country does little direct trade with Israel but Israel and this country both do a great deal of exporting to a third country, the weight of the competing country in Israel's real exchange-rate index will be greater than if computed only in view of said country's share in Israel's imports and/or exports, as is conventionally done.[4]

Figure 1 and Table 1 show the real exchange-rate indices that were calculated for the years 1995–2004.[5] Figure 2 juxtaposes the nominal effective exchange rate index with the exchange rates of the US dollar and the five-currency "basket." The index shown uses the multilateral weights to

Figure 1
Indices of the Real Exchange Rate, 1995–2004
(1995:I = 1)



SOURCE: Bank of Israel Foreign Exchange Activity Department.

[3] Zanello, A., and Desruelle, D. (1997), "A Primer on IMF's Information Notices System," IMF Working Paper WP/97/71.

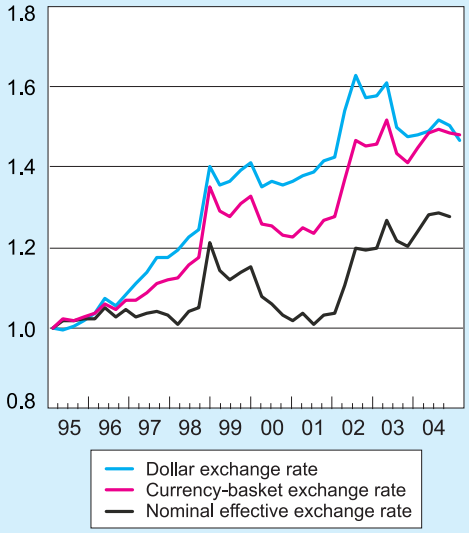
[4] Thus, the share of the US in the index is about 5 percentage points lower than its share in a simple index and the shares of Canada, China, and other open economies are higher.

[5] Since global export prices are obtained at a lag, the index according to these prices was calculated only up to the third quarter of 2004.

weight the nominal exchange rates against the NIS of the currencies of all countries that participate in the index. Over time, as the figure shows, the real indices fluctuate severely and sometimes even move in opposite directions.

Some of the indices are built in a way that also allows us to analyze each country's contribution to the change in the real exchange rate during a certain period of time. For example, we divided the change in the real exchange rate, measured on the basis of the ratio of consumer price indices, into four blocs of countries (Table 2).[6] This illuminates the effect of the volatility of the euro exchange rate on Israel's real exchange rate. In 1999–2000, for example, real appreciation in Israel was caused mainly by the global depreciation of the euro, whereas in 2001–2004 real depreciation in Israel was occasioned largely by appreciation of the euro. The year 2003 stood out in particular, as the slight real appreciation against the dollar did not manage to cancel out the real depreciation that occurred mostly against the euro zone but also against the other blocs.

Figure 2
Indices of Nominal Exchange Rate, 1995–2004 (1995:I = 1)



SOURCE: Bank of Israel Foreign Exchange Activity Department.

Table 1
The Annual Rate of Change (December to December)[a] in Indexes of the Real Exchange Rate 2001 to 2004

(percent)

The index of the real exchange rate calculated according to:	Ratio of import prices to export prices	Index of export prices	Cost of a unit of labor	Ratio of prices of tradables to non-tradables	CPI	Nominal effective exchange rate
Rate of change in 2001	–1.8	1.7	2.2	–4.0	2.3	1.0
Rate of change in 2002	0.1	3.7	28.6	0.1	12.3	16.3
Rate of change in 2003	3.9	7.0	2.3	1.5	7.9	3.7
Rate of change in 2004	0.7	0.0	11.2	1.1	5.7	4.1

[a] For the index according to import prices, the figures are updated up to the third quarter of 2004.
SOURCE: Processed data of the Foreign Exchange Activity Department

[6] The table should be read in the following way: In 2003, there was a 7.9 percent real depreciation. The US contributed –0.7 percent to this depreciation even though its share in the index was 24 percent. Thus, there was a 2.9 percent real depreciation against the dollar that year (0.7/0.24). The same procedure yielded average real depreciation of 17.1 percent against the Euro zone countries (6/0.35).

Table 2
The Rate of Change in the Real Exchange Rate during the Year (December to December) according to the CPI Breakdown According to Blocs of Countries, 1999–2004

(percent)

Year	Total real depreciation[a]	The contribution to the real depreciation in percentage points of: Emerging economies (21%)[b]	US (24%)[b]	Euro bloc (35%)[b]	Rest of OECD countries (20%)[b]
1999	–4.5	–0.2	0.4	–4.6	0.3
2000	–6.3	–0.7	0.2	–3.8	–1.8
2001	2.3	–0.2	1.2	1.7	–0.2
2002	12.3	1.6	1.3	7.0	2.7
2003	7.9	0.8	–0.7	6.0	2.2
2004	5.8	1.3	0.2	2.8	1.4

[a] The columns add up to the total real depreciation except for the deviation resulting from the approximation to the sum of rates of change.
[b] In parenthesis: weight of the bloc in the index.
SOURCE: Processed data of the Foreign Exchange Activity Department.

In sum, as stated, the real exchange rate affects the trends in the goods and services account. Different indicators, however, may sometimes point to different trends in the real exchange rate. Thus, it is important to observe several indicators. In recent years, all indicators pointed to real depreciation (Table 1, Figure 1), particularly in the past two years, when the nominal exchange-rate indicators suggested relatively stability (Table 1, Figure 1). This depreciation had a narrowing effect on Israel's trade deficit.

2. THE GOODS ACCOUNT

a. General remarks

Activity expanded by 20 percent. The deficit came to $ 2.4 billion, similar to the 2003 level but smaller than the deficit in 2000–2002.

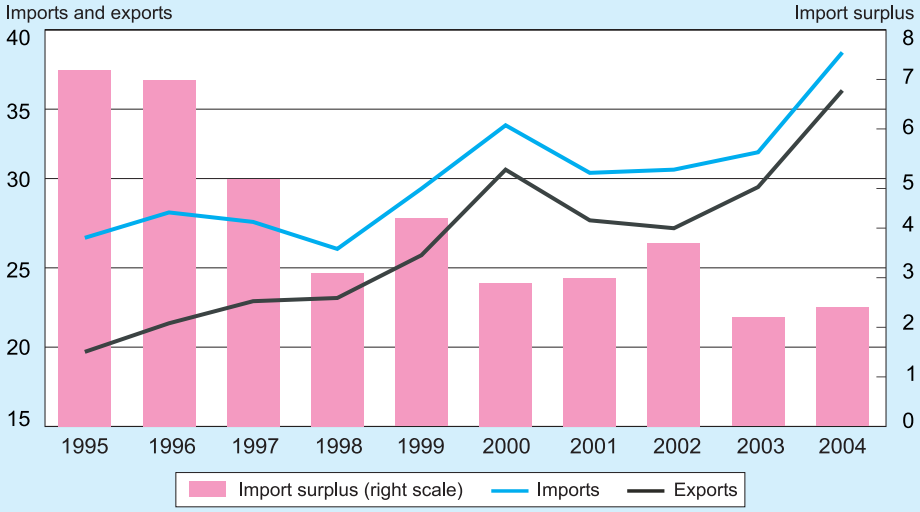
The goods account increased by about 20 percent in 2004 as both exports and imports continued to expand. The deficit on goods account was $ 2.4 billion, similar to the 2003 level but $ 0.8 billion smaller than the average deficit in 2000–2002 (Figure 1.2.3). The private-sector deficit was $ 0.4 billion, largely unchanged from the previous year.

All types of imports trended up during the year. Fuel prices made a conspicuous contribution to the increase, climbing by 30 percent during the year and leading a $ 0.9 billion upturn in energy imports. Defense imports came to $ 1.9 billion, similar in volume to the 2003 level. Exports increased at all levels of technology intensivity. High-tech exports, which account for nearly half of industrial exports, grew by 22 percent.

Terms of trade excluding diamonds and energy worsened by 1.6 percent in 2004.

Terms of trade in goods deteriorated by 1.6 percent (2004 average as against all of 2003). Much of the downturn was occasioned by a 26.9 percent increase in energy

Figure 1.2.3
The Goods Account: Imports, Exports and the Import Surplus, 1995–2004 (balance of payment data, $ billion)

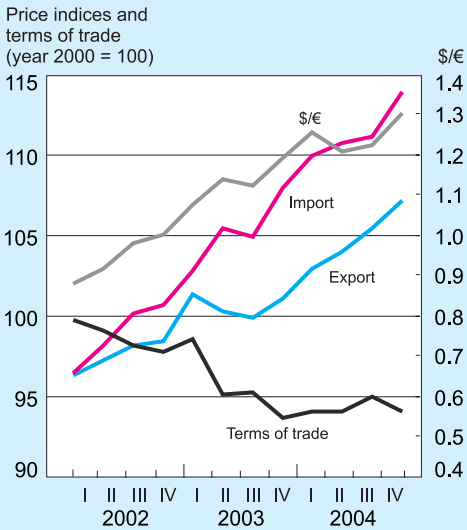


SOURCE: Central Bureau of Statistics.

prices. In contrast, the terms of trade of the diamond industry improved by 5.5 percent. Since the energy and diamond factors canceled each other out, the terms of trade excluding diamonds and energy, reflecting most foreign-trade activity, worsened in 2004 by 1.6 percent (Table 1.2.3).

The worsening of terms of trade began in the fourth quarter of 2003 (Figure 1.2.4). The moderate improvements in the first three quarters of 2004 did not change the trend because the downtrend (excluding diamonds and energy) resumed in the fourth quarter. The deterioration traces partly to the appreciation of the euro against the dollar (Figure 1.2.4), occasioned by the larger share of the euro zone in imports than in exports.

Figure 1.2.4
Price Indices and the Terms of Trade, 2002–04 (quarterly, excluding ships, aircraft, diamonds and fuel)



SOURCE: Based on Central Bureau of Statistics data.

Table 1.2.3
The Change in Import and Export Prices and the Terms of Trade, 2004

(annual average, percent)

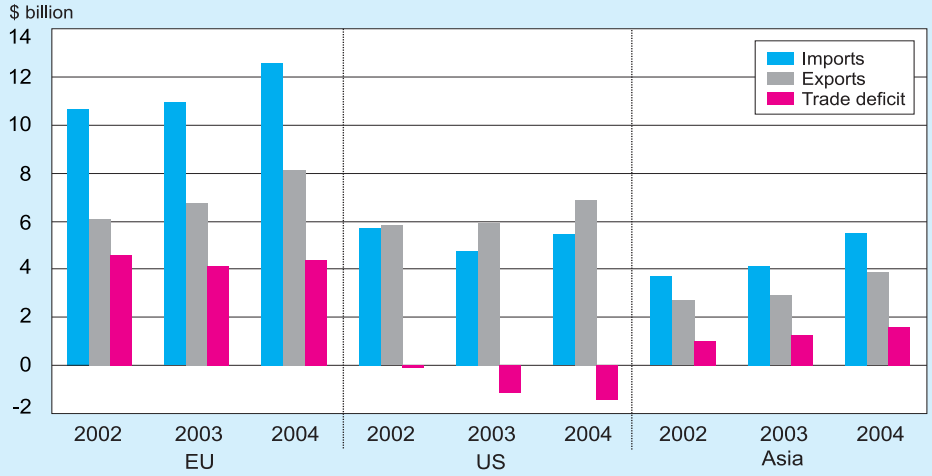
	Import prices	Export prices	Terms of trade
Total	7.1	5.4	–1.6
Of this: diamonds	2.0	7.6	5.5
Total without diamonds[a]	8.3	4.1	–3.9
Of this: energy	26.9		
Total without diamonds and enery[a]	5.8	4.1	–1.6

[a] And without planes and ships.
SOURCE: Central Bureau of Statistics

b. Nondiamond trade deficit by main trading areas

The balance-of-payments data on goods account of the private sector differ from the net foreign-trade data for several reasons. In 2004, the difference came to $ 6.4 billion.[3]

Figure 1.2.5
Imports, Exports and the Trade Deficit,[a] by Trading Regions, 2002–04



[a] Excluding diamonds.
SOURCE: Based on Central Bureau of Statistics data.

[3] The main reasons for the difference between the two sets of data, along with the relevant data for 2004, are the following: (a) The import and export data in the balance of payments are recorded on an FOB basis, i.e., excluding haulage and insurance expenses. The data concerning these import expenses, if paid to external players, are recorded on the respective lines of the services account. (b) The foreign-trade data do not include activity vis-à-vis the Palestinian Authority (a $ 1.1 billion surplus). (c) The balance-of-payments data include various corrections that are not performed on the foreign-trade data. In 2004, the export data in the balance of payments were corrected upward by $ 0.9 billion and the import data were adjusted downward by $ 4.1 billion. The balance-of-payments data also include $ 1.9 billion in defense imports.

However, the use of foreign-trade data makes it possible to segment the data by trading areas and technology intensivity. Therefore, the following analysis of developments in the goods account of the private sector is based on the foreign-trade data, i.e., net data and banks' reports to the Foreign Exchange Activity Department.

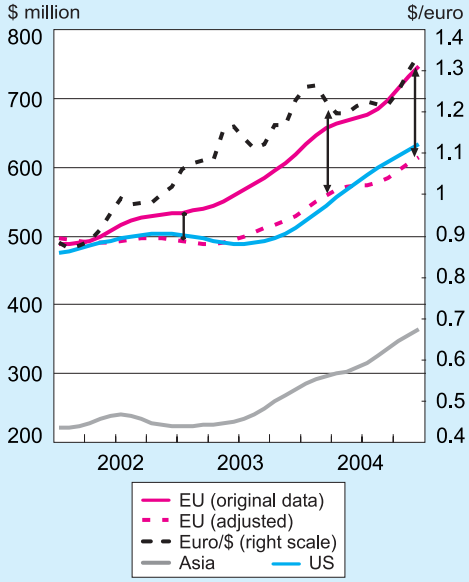
The nondiamond trade deficit (according to the foreign-trade data) was $ 7.3 billion in 2004, $ 1 billion larger than in 2003. Most of the deficit ($ 4.4 billion) occurred in trade with the European Union, the deficit in trade with Asia was $ 1.6 billion, and trade with the US ended with a surplus of $ 1.4 billion (Figure 1.2.5). Since 2001, the trade balance with the US has improved by $ 1.8 billion, corresponding to the general uptrend in the US deficit on goods account. The deficit vis-à-vis the EU increased by $ 0.3 billion in 2004, of which an estimated $ 0.2 billion traced to the appreciation of the euro against the dollar. The deficit with China expanded by $ 0.2 billion and came to $ 0.7 billion, part of the global uptrend in deficits of developed countries (foremost the US) with China.

Since the foreign-trade data are dollar-denominated, they do not fully reflect the developments because the appreciation of the euro against the dollar has increased the value of exports and imports from Europe in dollar terms. This effect was evident in 2002–2003 but less so in 2004, when the euro appreciation was confined to the last quarter. Reports from banks to the Foreign Exchange Activity Department show that 18 percent of export receipts in 2004 were in euros and 76 percent in dollars and that 22 percent of import payments were made in euros and 71 percent in dollars. To estimate the trend in Israel's imports and exports vis-à-vis the EU, the effect of the euro appreciation against the dollar was deflated in accordance with the share of financial movements that took place in euros, yielding an adjusted value of trade with the EU countries.

The adjusted data show that the growth rate of exports to the EU slowed in mid-year and accelerated in the last quarter, whereas the growth of exports to the US eased off in the second half as the growth of high-tech exports slowed. Exports to Asia continued to trend up (Figure 1.2.6).

According to the adjusted import data, the growth rate of imports from

Figure 1.2.6
Exports, by Trading Area, 2002 and 2004 (monthly trend data, deflated by change in euro)



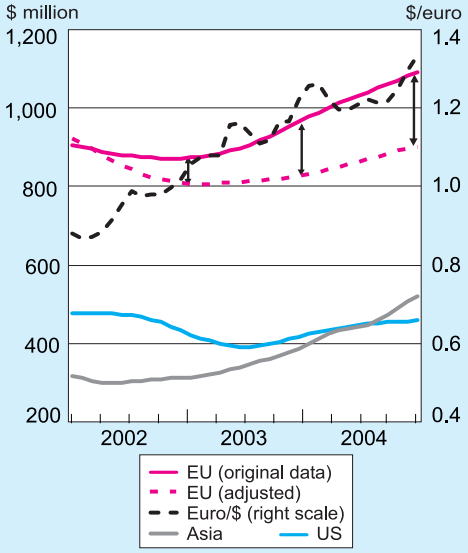
[a] Excluding diamonds.

SOURCE: Based on Central Bureau of Statistics.

the United States slowed considerably in the second half of the year and imports from the European Union trended up but less intensively than imports from Asia (Figure 1.2.7). Imports from the last-mentioned continent increased by 30 percent in 2004 and imports from China and Japan, which account for about half of imports from Asia, expanded by 40 percent apiece. Imports from China continued to grow at the 2003 pace of 27 percent and came to $ 1.4 billion. The upturn in the share of imports from Asia and, especially, the increase in imports from China at the expense of other countries are evidently related to the availability of lower prices in China due to low labor costs and the indexation of the Chinese currency to the US dollar. This process is part of the upturn in competition from developing countries, which is crowding out developed countries as sources of imports. Another possible reason was the appreciation of the euro since 2002, which made imports from Europe more expensive and imports from Asia less so in relative terms.

Imports from Asia continued to grow at the expense of imports from other countries. Imports from China came to $ 1.4 billion, up 40 percent.

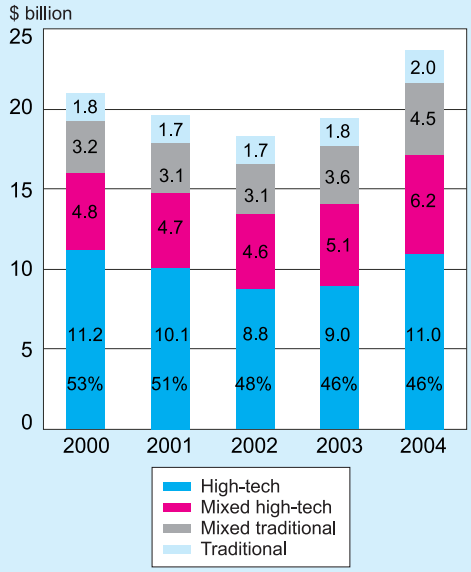
Figure 1.2.7
Imports, by Trading Area, 2002–2004 (monthly trend data, deflated by change in euro)



[a] Excluding diamonds.

SOURCE: Based on Central Bureau of Statistics.

Figure 1.2.8
Manufacturing Exports, by Industry, 2000–04 (share in percent)



SOURCE: Based on Central Bureau of Statistics data.

c. Sectoral analysis of civilian exports and imports

Nondiamond exports of goods increased by 22 percent.

Net exports of goods, according to the foreign-trade data excluding diamonds, increased by $ 4.4 billion in 2004 (22 percent) and came to $ 24.4 billion. Industrial exports expanded by 22 percent and agricultural exports—3 percent of the total—increased by 27 percent and ended the year at $ 0.9 billion. The annualized export growth

Table 1.2.4
Manufacturing Exports, by Technological Intensity (Gross), 2000–2004

(year-on-year rate of change, percent)

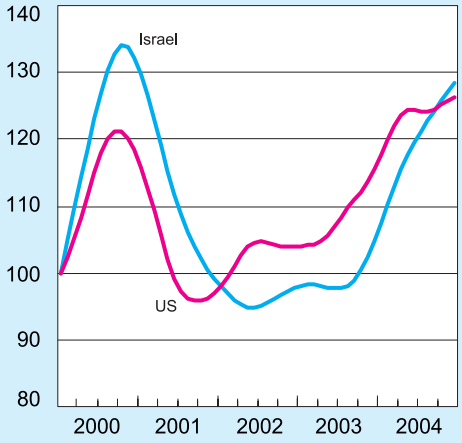
	Rate of change					Exports	Distribution
	2000	2001	2002	2003	2004	2004	2004
						($ million)	
Total exports excl. polished diamonds	27.9	–6.8	–6.5	6.2	22	19,255	100
High-tech industry[a]	49.1	–10.0	–12.6	2.3	22	8,865	46
Mixed high-tech industry[b]	16.6	–2.6	–1.5	9.7	22	5,051	26.2
Mixed traditional industry[c]	5.7	–2.2	1.5	13.2	25	3,541	18.4
Traditional industry[d]	2.2	–5.8	1.1	4.5	12	1,798	9.3

[a] High-tech industry: office machines and computers, electronic components, aircraft, communications and electronics equipment,
monitoring and supervisory equipment, pharmaceuticals.
[b] Mixed high-tech industry: chemicals, oil refining, machinery and equipment, electrical motors and equipment, motorized vehicles and other land transport equipment.
[c] Mixed traditional industry: mining and quarrying, rubber and plastics, non-metallic minerals, non-ferrous precious metals, metal and steel products, sailing boats, jewelry and goldsmithing, and miscellaneous.
[d] Traditional industry: food, beverages and tobacco, textiles, clothing and leather, paper, printing and its products, wood products, furniture.
SOURCE: Based on Central Bureau of Statistics data.

rate slowed from 30 percent in the first quarter of the year to 15 percent later on. The volume increase in exports (export value deflated by the increase in export prices) was 17 percent. Industrial exports surpassed the record level of 2000 and high-tech exports approached the peak that was attained that year. The share of high-tech in total industrial exports was 46 percent in 2003–2004 as against 53 percent in 2000 (Figure 1.2.8).

The increase in industrial exports occurred at all levels of technology intensity. Exports of high-tech and medium-high-tech industries expanded by 22 percent, those of medium-low technology industries by 25 percent, and those of low technology industries by 12 percent.

Figure 1.2.9
Weighted Index of High-Tech Exports from Israel and US High-Tech Imports, 2000–04
(trend data, Jan. 2000 = 100)

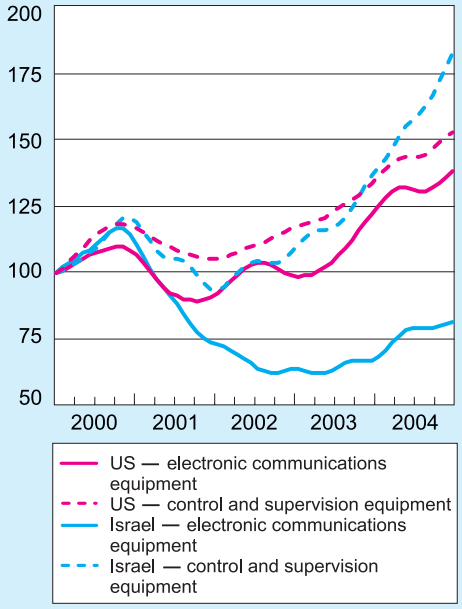


SOURCE: Israel — Central Bureau of Statistics.
US — data based on United States International Trade Commission data.

High-tech industry has been the locomotive of growth in Israel during the past decade. Figure 1.2.9 describes Israel's high-tech exports alongside high-tech imports of the United States,[4] an indicator of

[4] The US is the destination of about 40 percent of Israel's high-tech exports.

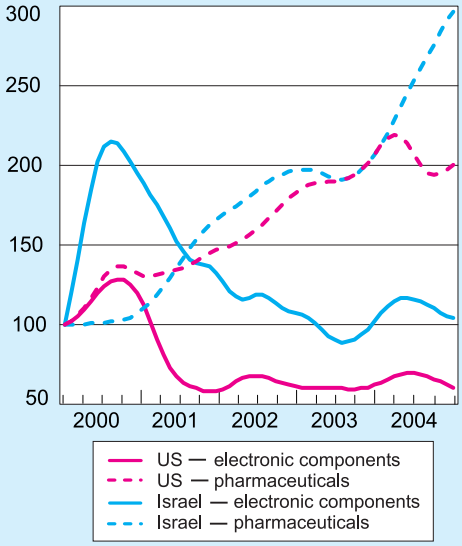
Figure 1.2.10
Index of Exports of Electronic Communications Equipment and Control and Supervision Equipment,[a] 2000–04
(trend data, Jan. 2000 = 100)



[a] Each constituting 26 percent of high-tech exports.

SOURCE: Israel — Central Bureau of Statistics. US — data based on United States International Trade Commission data.

Figure 1.2.11
Index of Exports of Electronic Components and Pharmaceuticals,[a] 2000–04 (trend data, Jan. 2000 = 100)



a Constituting 16 percent and 9 percent respectively of high-tech exports.

SOURCE: Israel — Central Bureau of Statistics. US — data based on United States International Trade Commission data.

global demand. The comparison shows that whereas the global economy began to recover back in 2002—as measured by the trend in American imports—Israel's high-tech exports began to grow only in the second half of 2003. The belatedness of the recovery traces mainly to developments in the electronic communications equipment industry, which continued to slump despite the global recovery, and in the electronic components industry, which continued to decline even as global demand stabilized (Figures 1.2.10 and 1.2.11). The lag is evidently related to the concentration of Israel's exports in market segments that do not always behave like the rest of the industry, in the partial loss of the technological edge that Israeli firms had once had, and in competition from developing countries.

In the first half of the year, high-tech exports grew in tandem with global demand. In the second half of the year, global demand stopped growing but the growth rate of Israel's exports merely slowed. This happened because exports of pharmaceuticals continued to trend up even though demand declined until the last quarter of the year and because exports of control and supervision equipment continued to growth even as global demand slowed (Figures 1.2.10 and 1.2.11). Notably, much activity in electronic components and pharmaceuticals is performed by one company in each industry, affecting the volatility of these industries' exports.

Table 1.2.5
Exports (gross) of Selected Industries, 2000–04

(year-on-year rate of change, percent)

	2000	2001	2002	2003	2004	Exports 2004	Distribution 2004	Change in price 2004	Volume change 2004
	Rate of change in current dollars					$ million			
Total manufacturing exports	26.6	–6.5	–1.1	6.2	20.3	34,219	100.0	5.3	14.2
Total exports, excl. polished diamonds	27.9	–6.9	–6.4	6.2	21.6	23,646	69.1	4.0	16.9
Textiles, clothing, and leather	0.7	–9.0	–3.6	–1.0	10.2	1,094	3.2	2.9	7.1
Chemicals and oil refining	18.5	1.2	9.7	11.7	26.5	5,809	17.0	12.0	13.0
Rubber and plastics	4.0	0.5	0.8	18.2	17.2	1,503	4.4	4.4	12.3
Basic metal products	8.9	–4.6	–2.5	3.0	35.4	1,375	4.0	9.4	23.8
Machinery and equipment	11.0	2.2	–11.8	9.3	21.0	1,340	3.9	6.4	13.7
Electronic components and computers	146.9	–16.1	–23.3	–6.5	18.6	2,601	7.6	–4.2	23.9
Equipment: communications, control, medical, scientific	30.8	–13.0	–18.7	7.4	25.0	5,719	16.7	–0.2	25.3
Transport vehicles	4.4	3.5	10.8	5.4	9.5	1,340	3.9	–0.6	10.2
Polished diamonds	23.3	–5.4	12.7	6.2	17.6	10,572	30.9	8.4	8.4
Agriculture	–10.3	–10.2	–1.6	15.2	27.1	909		7.4	18.4

SOURCE: Based on Central Bureau of Statistics data.

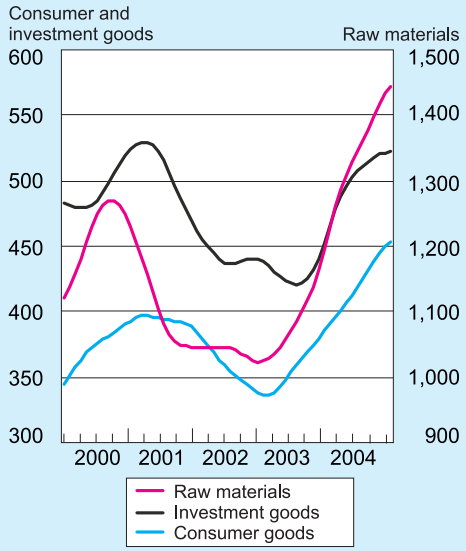
Exports of medium-high-tech and medium-low-tech industries continued to grow conspicuously, at 27 percent in chemicals and oil refining and 17 percent in rubber and plastics (Table 1.2.5).

Imports of goods excluding diamonds, ships, and aircraft increased by 21 percent.

Net imports of goods excluding ships, aircraft, and diamonds, according to the foreign-trade data, were $ 31.7 billion in 2004, up 21 percent (Table 1.2.6). Total imports net of energy products (in addition to the exclusion of ships, aircraft, and diamonds) expanded at the same rate. All types of imports (raw materials, consumer goods, and capital goods) trended up during the year. The most salient growth (23 percent) occurred in raw materials, which account for about two-thirds of total nondiamond imports (Figure 1.2.12). Deflated by the increase in import prices, the quantity increase in imports was 13 percent overall and 14 percent net of energy products.

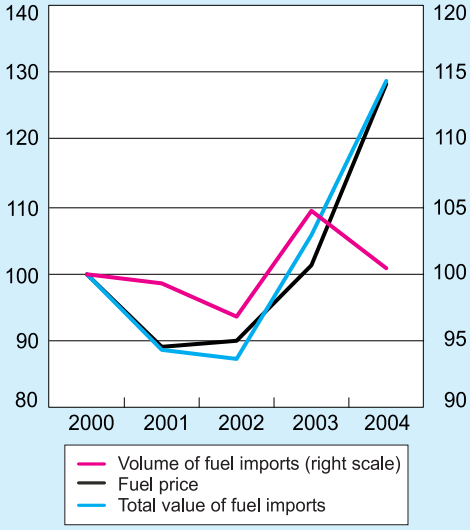
The value of energy imports was $ 4.5 billion in 2004, up 22 percent, due to a 27 percent increase in energy prices (2004 average as against all of 2003) and a 4 percent decline in the quantity of energy products imported (Figure 1.2.13). Most of the price increase and the decline in quantity imported occurred in the second half of the year. The quantity decreased due to the changeover by the Israel Electric Corp. to locally produced gas and not to the effect of prices. Data for previous years show that price increases have almost no effect on quantities imported. One reason is that the high taxation of some petroleum distillates is not a function of the price of crude oil. Therefore, changes in the price of crude oil are only partly passed on to consumers (Figure 1.2.13). Although fuel prices climbed throughout the year, the rate of increase

Figure 1.2.12
Development of Main Import Components, 2000–2004
(monthly trend data, $ million)



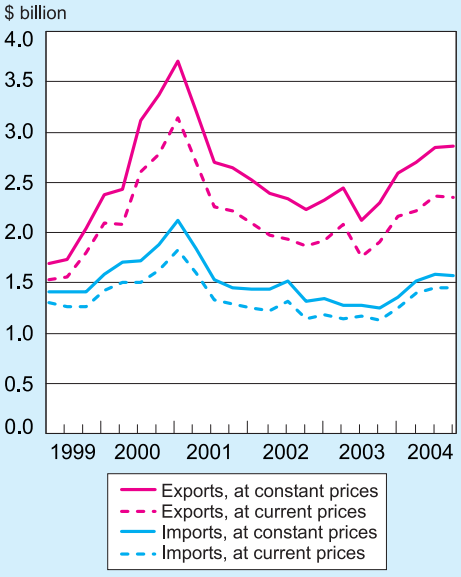
SOURCE: Based on Central Bureau of Statistics data.

Figure 1.2.13
Index of the Value of Fuel Imports, the Price of Fuel and Volume of Imports
(annual average, 1999 = 100)



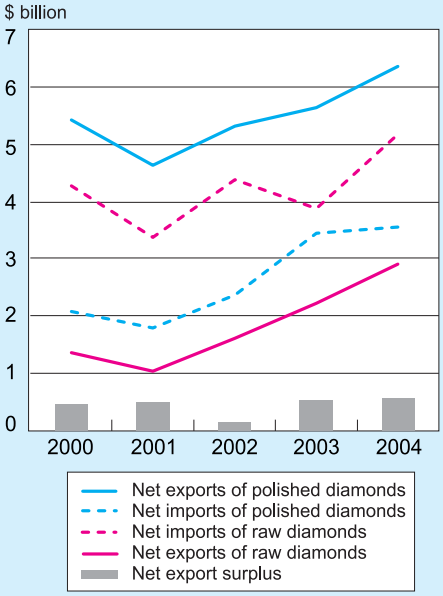
SOURCE: Based on Central Bureau of Statistics data.

Figure 1.2.14
Exports of High-Tech Industries Excluding Pharmaceuticals, and Imports for the Machinery and Electronics Industries, March 1999 to September 2004 (quarterly)



SOURCE: Central Bureau of Statistics.

Figure 1.2.15
The Diamond Industry: Net Imports and Exports, and the Net Export Surplus, 2000–04



SOURCE: Central Bureau of Statistics.

Table 1.2.6
Imports of Goods net, by Group, 1999–2003

(year-on year rate of change, percent)

						Imports	Distribution	Change in price	Volume change
	2000	2001	2002	2003	2004	2004	2004	2004	2004
	Rate of change of current dollars					NIS million			
Total imports	15.0	–7.2	–0.4	3.5	20.1	40,489	100.0	7.1	12.3
Total imports, excl. ships, aircraft, and diamonds	17.1	–6.1	–5.0	3.0	20.7	31,743	78.4	8.3	11.4
Total imports, excl. ships, aircraft, diamonds, and energy imports	12.5	–5.4	–5.5	0.6	20.5	27,239	67.3	5.8	13.9
Consumer goods	13.8	3.5	–6.9	–1.8	18.6	5,048	12.5	4.2	13.8
Raw materials	13.3	–10.3	–4.3	3.5	23.6	16,118	39.8	7.8	14.5
of which Imports for machinery and electronics industries	22.9	–15.5	–10.9	–3.7	25.0	5,850	14.4	1.2	23.6
Capital goods	9.6	0.2	–7.0	–4.3	14.6	6,036	14.9	2.2	12.1
Energy inputs	65.8	–11.5	–1.4	21.2	21.7	4,503	11.1	26.9	–4.1
Rough and polished diamonds	16.5	–18.8	31.1	8.3	18.8	8,718	21.5	3.5	14.9
Ships and aircraft	–67.3	178.8	–60.6	–72.3	–61.6	28	0.1		
Other	38.6	–17.0	21.5	28.9	24.4	37	0.1		

SOURCE: Based on Central Bureau of Statistics data.

accelerated in the second half. The price of oil climbed from $ 32 per barrel (Brent) at the beginning of the year to $ 52 in October and fell back to around $ 40 at year's end.

Imports of raw materials for the machinery and electronics industry increased by 25 percent (Table 1.2.6) due to the strong relationship between these industries' exports and the expansion of their activity and their imports (Figure 1.2.14). Raw-materials imports for mixed high-tech industries also increased perceptibly: 16 percent in chemicals and 31 percent in rubber and plastics. Due to the relationship between imports and exports, the upturn in imports late in the year should be reflected in an increase in exports in the near future.

Imports of consumer goods increased by 19 percent over 2003 after slipping by 2 percent in 2003 relative to 2002 (Table 1.2.6). Increases were reported in all types of consumer goods, especially durable goods (furniture and domestic electrical equipment and transport equipment), which increased by 27 percent under the stimulus of domestic growth. The growth was also reflected in a 15 percent increase in imports of investment goods.

The diamond industry had a $ 0.6 billion export surplus in 2004, as in 2003. Net exports and imports of diamonds increased by 18 percent and came to $ 9.3 billion and $ 8.7 billion, respectively. The 2004 data show again that Israel has become more of a trading center that a production center. Exports of uncut stones for production abroad continued to increase, as did the high proportion of polished stones that were returned unsold after being exported to overseas offices for sale.

Net exports of rough diamonds expanded by 30 percent in 2004 after 50 percent annual growth in each of the previous two years (Figure 1.2.15). The return rate of polished stones (around 40 percent in recent years) is reflected in the gap between the industry's gross and net data, unlike other industries, in which the gap is negligible (less than 1 percent).

3. THE SERVICES ACCOUNT

Activity on services account expanded by 12 percent. The surplus on services account was $ 0.7 billion, up $ 0.4 billion.

Activity on services account continued to expand in 2004, by 12 percent, recovering to the 2000 level. Net revenues increased by $ 0.4 billion. The dominant line on services account, in both the extent of activity and in its contribution to the improvement in the past two years, was "Other Services," in which revenues increased by $ 0.7 billion for the second consecutive year. Net tourism revenue also increased slightly, net expenditure for cargo and transport services climbed, and the (net) insurance line has been level for the past two years (Table 1.2.7).

Exports of computer and R&D services increased 18 percent in 2004—four times the growth rate of the global IT industry.

Exports of computer and R&D services, the mainstays of the information-technology industries, generate about 50 percent of revenues of "Other Services" and accounted for nearly 60 percent of the upturn in service-export revenues in 2004. Computer and R&D service exports came to came to $ 4.3 billion in 2004, up 18 percent—four times the growth rate of the global IT industry—after 16 percent growth in 2003 and decreases in previous years. Due to the upturn in the growth rate of computer and R&D service exports as against slower growth of exports in other service industries, the share of these industries in total non-tourism service exports has risen in the past two years (Table 1.2.8).

Foreign workers account for 37 percent of tourism revenues.

The tourism component of the balance of payments includes, in addition to tourist revenue, revenue from the basic living expenses of foreign workers. Since the last quarter of 2000, when the current security unrest began, these revenues have been an important component in tourism revenue due to the steep decrease in inbound tourism (Figure 1.2.16). In 2004, tourists generated $ 1.5 billion in revenue and foreign workers generated $ 0.9 billion—37 percent of total revenues on the tourism line (in regard to foreign workers, see Section 4).

The recovery of inbound tourism that began in the second quarter of 2003, upon the end of the active phase of the war in Iraq, gathered momentum in 2004 as the regional geopolitical situation improved. Some 1.5 million tourists entered the country in 2004, up 41 percent from 2003. This extent of inbound tourism approximates the 1992 level but falls short of 2.4 million arrivals in 2000, the peak tourism year (Figure 1.2.16).

Tourists spent more in Israel and Israelis spent more abroad.

Estimated tourism revenues in the balance of payments increased at a pace commensurate with the upturn in inbound tourism and revenue per tourist remained stable at the 2003 level of $ 1,000. According to data from the Ministry of Tourism for the first half of 2004,[5] the average tourist spent three fewer days in Israel in 2004

[5] See the inbound-tourism tourism survey in the Ministry of Tourism's semiannual report for January–June 2004 (Hebrew).

Table 1.2.7
Services Account, 2000–2004

($ million)

	2000	2001	2002	2003	2004
1. Net services account	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
1.1 Net cargo and transport services	–2,406	–2,315	–2,079	–1,945	–2,312
Exports	2,482	2,122	2,121	2,595	3,050
Imports	–4,887	–4,437	–4,200	–4,540	–5,362
1.2 Net tourism	1,270	–482	–503	–511	–413
1.2.1 Tourism revenue	4,074	2,463	2,039	2,039	2,383
Revenue from tourists	3,133	1,378	919	1,071	1,499
Revenue from foreign workers	941	1,085	1,121	968	884
1.2.3 Israelis' external expenditure	–2,804	–2,945	–2,543	–2,550	–2,796
1.3 Net insurance	–313	–300	–363	–419	–418
1.4 Other services	3,598	2,615	2,607	3,372	4,048
Exports	7,884	7,144	6,779	7,577	8,730
Thereof: Computer and R&D services	4,246	3,471	3,143	3,656	4,322
Imports	–4,286	–4,529	–4,172	–4,205	–4,682
1.4 Government services, n.e.s.	–116	–161	–174	–185	–181

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

Table 1.2.8
Services Exports of Computer and R&D Services (IT) Industries, 2000–2004

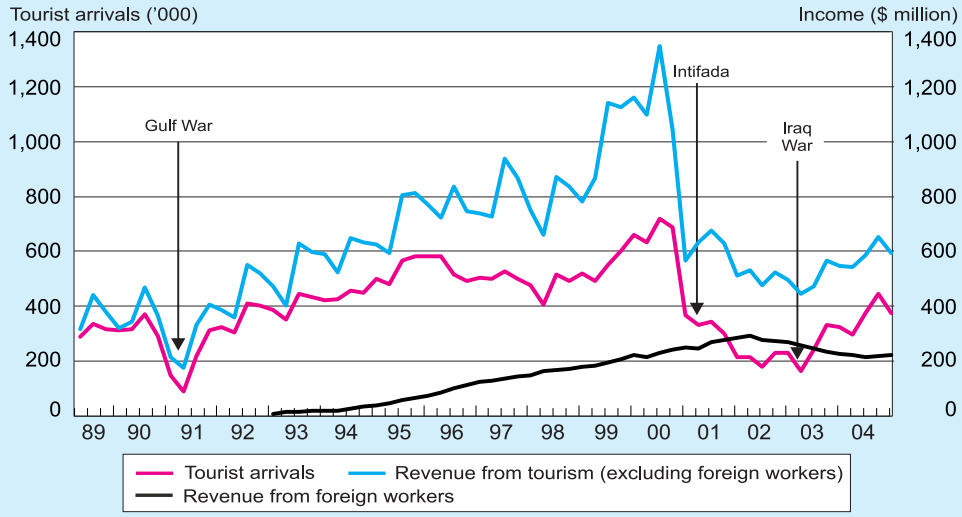
Year	Exports of services excl. tourism	Exports of IT services	Annual change in IT exports	Share of IT industries in services exports
	($ billion)		(percent)	
2000	10.5	4.2	116.9	40.6
2001	9.3	3.5	–18.3	37.2
2002	8.9	3.1	–9.4	35.2
2003	10.2	3.7	16.3	35.8
2004	11.8	4.3	18.2	36.5

SOURCE: Based on Central Bureau of Statistics data.

than in 2003—nineteen as against twenty-two—but spent slightly more each day. The increase originates in a halt in the trend of changes in the characteristics of inbound tourism in 2001–2003 that had reduced revenue per tourist-day during those years. These indicators improved in 2004 (Figure 1.2.17). The main changes had been a decline in the proportion of tourists who stayed in hotels and resort villages and an increase in the proportion of those who stayed with friends and relatives, a decrease in the proportion of tourists who came for recreation and sightseeing purposes, and an upturn in the share of tourists who came to visit relatives and friends.

The number of Israeli departures to foreign destinations increased by 10 percent in 2004 and the Israelis' estimated spending abroad rose commensurably. Since the increase in spending was smaller than the upturn in tourism revenue; the tourism data in the balance of payments improved slightly relative to 2003.

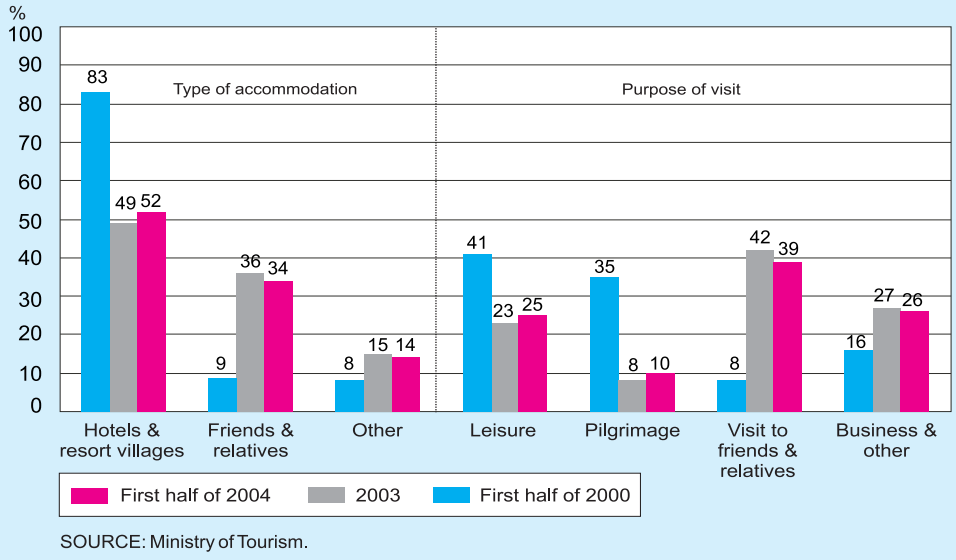
Figure 1.2.16
Tourist Arrivals and Income Therefrom and from Foreign Workers, 1989–2004 (quarterly)



SOURCE: Central Bureau of Statistics.

The **net transport** item on services account has been flat in the past three years but activity in terms of revenue and expenditure continued to grow as in 2003. Salient developments in 2004 included a 16 percent increase in revenues from cargo services between foreign ports by Israeli companies for nonresidents. Revenue on account of these services came to $ 1.8 billion and accounted for 60 percent of total revenues. Concurrently, expenditure for the importation of goods by foreign carriers increased by 24 percent at $ 2.3 billion, 43 percent of expenditure.

Figure 1.2.17
Characteristics of Incoming Tourism, 2000, 2003 and 2004



SOURCE: Ministry of Tourism.

4. FACTOR-INPUTS ACCOUNT

Net interest expenditure by general government increased by 20 percent; that of the private sector declined by 55 percent.

Net expenditure on factor-inputs account was $ 4 billion in 2004, 4 percent more than in 2003 (Table 1.2.9). It was divided almost equally between two lines: interest-and-dividends and labor wages. Total net interest expenditure increased by 1.5 percent but while general government increased its net expenditure by 20 percent, the private sector reduced its net interest outlays by 55 percent.

Table 1.2.9
Factor Input Revenues, 2000–2004

($ million)

	2000	2001	2002	2003	2004
Net factor input revenues	–7,202	–4,933	–4,109	–3,873	–4,022
1. Net interest and profits	–3,985	–1,999	–1,566	–1,655	–2,028
Net interest of the public sector	–736	–707	–804	–1,034	–1,245
Revenues	1,049	987	792	571	518
Expenses	–1,785	–1,694	–1,597	–1,605	–1,763
Private sector	–3,248	–1,291	–762	–621	–783
Interest	–1,231	–212	–217	–344	–154
Revenues	1,954	1,774	1,264	960	1,144
Expenses	–3,185	–1,985	–1,481	–1,304	–1,298
Dividends and profits	–2,018	–1,080	–545	–278	–629
Revenues	361	–287	172	1,038	451
Expenses	–2,379	–793	–717	–1,315	–1,080
2. Net labor wage	–3,217	–2,934	–2,543	–2,217	–1,994
2.1 Labor wage expenses	–2,283	–2,579	–2,343	–1,956	–1,751
2.2 For workers from PA areas	–979	–400	–232	–282	–275
2.3 For other foreign workers (net)	45	45	31	21	32

SOURCE: Based on Central Bureau of Statistics data.

Two factors explain the $ 0.2 billion increase in the net interest expenditure of general government: a slight downturn in income from the foreign reserves and an upturn in interest payments on the government's external debt. The increase in US short-term interest rates that began in the second half of the year was only partly reflected in the revenues of the Bank of Israel and will be expressed mainly in future revenues, after a larger share of the central bank's forex assets earn higher interest. The government's interest outlays increased in 2004 due to a $ 3 billion upturn in its external debt relative to September 2003, when the first bond issue under the current US guarantees arrangement was made (for further detail, see Section 6 below). The increase in short-term interest rates had little effect on government expenditure because the government did most of its borrowing at fixed interest and for long terms.

Interest revenue of the private sector increased by 19 percent in 2004, mainly due to an $ 8 billion upturn in private-sector external assets while outlays remained at the previous year's level.

Expenditure on distributed and undistributed earnings in direct investment came to $ 1.1 billion, down 18 percent from 2003. Concurrently, direct external investment generated $ 0.5 billion in revenue, 57 percent less than in 2003. The decrease in

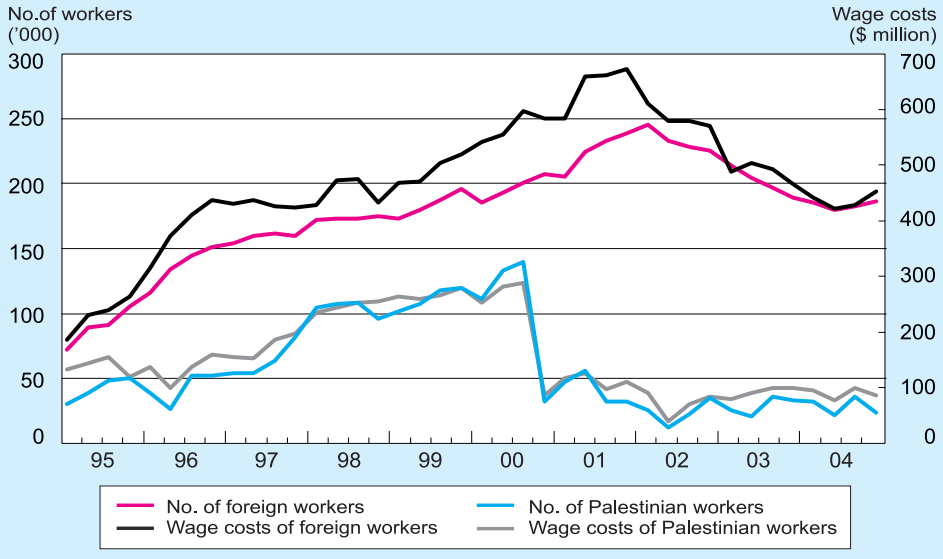
expenditure on payouts of earnings in direct foreign investment and the decrease in revenue from direct external investment originate mainly in accounting changes that affected reported earnings and not from a decrease in sales. (In fact, sales increased.) It should be noted that undistributed earnings are concurrently recorded as re-investments in Israel (see further detail in Chapter 3, which discusses investment in the context of the financial account).

The population of foreign workers has stopped declining.

On average, there were 9 percent fewer foreign workers in 2004 than in 2003 but the downtrend in their numbers stopped. The cutback in the foreign-worker population had little effect on the balance of payments because the revenue generated by these workers—from their basic-living expenses, which is recorded on the tourism line, and from the taxes they pay—declined concurrently.

The number of foreign workers whose wage expenses are included in the balance-of-payments data has been declining steadily since the peak of 246,000 in the first quarter of 2002 (Figure 1.2.18). Their number was estimated at 180,000 in the second quarter of 2004 and has been rising since then. In the last quarter of the year, the population of foreign workers was estimated at 187,000, including illegal workers and those who have been in the country for more than one year. The sum transferred by foreign workers to their families abroad, estimated on the basis of their wage less basic-living expenses and taxes, was estimated in 2004 at $ 0.7 billion, 40 percent of the wage outlay.[6]

Figure 1.2.18
Foreign and Palestinian Workers, and Wage Costs, 1995–2004 (quarterly data)



SOURCE: Based on Central Bureau of Statistics data.

[6] Reports by banks and moneychangers about foreign workers' wages sent abroad fall short of this estimate; evidently some of this money was acquired and sent out of the country by means other than banks and moneychangers.

The average population of workers from the Palestinian Authority areas remained at approximately the 2003 level, at 40,000 in the last quarter of 2004. The wage expenditure on their account was $ 0.3 billion.

5. CURRENT AND CAPITAL TRANSFERS

Current transfers to the private sector increased; transfers to general government contracted.

The private sector received $ 3.7 billion in current transfers in 2004, up 12 percent (Table 1.2.10), and residents transferred $ 1 billion abroad, down 4 percent. Personal restitution payments increased by $ 0.2 billion (22 percent). Half of the upturn traced to nonrecurrent restitution payments to former slave laborers; appreciation of the euro against the dollar explains the rest. While personal transfers increased by 5 percent, institutional transfers climbed by 25 percent, apparently due to fundraising efforts by institutions that rely on donations to cover much of their budget.

Table 1.2.10
Current Transfers and Capital Account, 2000–2004

($ million)

	2000	2001	2002	2003	2004
1. Total net current transfers	6,483	6,692	6,762	6,372	6,199
1.1 Net private sector transfers	2,131	2,383	2,362	2,296	2,730
1.1.1 Current transfers from abroad	3,057	3,439	3,655	3,357	3,745
Personal restitution	614	726	760	770	943
Cash transfers by institutions	565	429	424	435	542
Personal cash and goods transfers	1,878	2,284	2,471	2,152	2,259
Thereof: transfers to Israeli tourists abroad	264	283	241	236	261
1.1.2 Current transfers abroad	–926	–1,057	–1,293	–1,060	–1,015
1.2 Net public sector transfers	4,352	4,309	4,400	4,075	3,469
Thereof: from U.S. government	3,157	3,396	3,464	3,185	2,468
Transfers to govt. institutions	727	551	547	561	699
2. Net capital transfers	455	679	151	465	523
2.1 Private sector transfers	295	517	286	294	367
Thereof: transfers to institutions	87	255	84	92	77
2.2 Public sector transfers	161	162	–135	171	157

SOURCE: Based on Central Bureau of Statistics data.

Israel received $ 2.5 billion in transfers from the US Government in 2004, down by $ 0.7 billion after a $ 0.3 billion decrease in 2003. The civilian grant contracted by $ 120 million in 2004 as in previous years, under the arrangement with the US Government that is to phase out this grant in another two years (but adds half of the annual reduction to the defense grant). The defense grant also contracted this year due to a reduction in the share of the grant authorized for domestic use (see further detail in Section 6).

The private sector transferred $ 1 billion out of the country, slightly less than in 2003 and roughly equivalent to the 2000–2001 average. Current external transfers do not include money send to families abroad by foreign workers who have been in Israel

for more than a year. These transfers are recorded in Israel's balance of payments as part of the wage expenditure for foreign workers.

Net capital transfers to Israel were $ 0.5 billion in 2004, up 12 percent. Half of the total was performed by immigrants; the rest was received by institutions. The level of these transfers was much higher in the past two years than in 2002, when it was especially low due to an external transfer by the government.

6. CURRENT ACCOUNT OF GENERAL GOVERNMENT

General government includes the central government, the Bank of Israel, the Zionist National Institutions, and government institutions. The "government institutions" aggregate includes institutions that belong to government and those subventioned by government, e.g., institutions of higher schooling, research institutes, and medical institutions.

The surplus on general-government current account continued to contract.

General government has been running a surplus on current account for years, but the surplus has been contracting every year since 2001 and came to $ 0.1 billion in 2004 (Table 1.2.2). The decrease in 2004 occurred due to the decline in Bank of Israel income on the foreign reserves, due to lower global interest rates, and the upturn in government interest payments due to the increase in government debt in the aftermath of US -guaranteed borrowing.

The size of the current-account surplus of general government is permanently affected by the level of revenues of the Bank of Israel, the National Institutions, and government institutions. In the past five years, the last-mentioned had annual revenues of $ 0.8 billion. In contrast, the government usually has a deficit in its activity vis-à-vis the rest of the world, mainly due to interest payments.

Most government expenditure in foreign exchange is for defense imports and interest. From the opposite direction, US Government grants account for most of the government's foreign exchange revenue and usually suffice to cover these outlays. The government's current-account deficit increased by $ 0.7 billion in 2004 and came to $ 1.3 billion, mainly due to an increase in interest payments and the contraction of civilian and defense grants without a corresponding cut in defense imports. The government uses the civilian grant to repay loans and the military grant to pay for defense imports and domestic projects per agreement with the US Government. The US defense grants are recorded in the balance of payments on the basis of actual use by the defense system and not according to the outline that the US Government authorizes. Unlike the civilian grant, which is transferred to the government immediately after being approved by the US Administration, the defense grant is not handed over until defense imports from the US are made or against the presentation of documents about domestic military uses that are coordinated with the Administration. Defense-grant money that is approved but not used accrues to the following year's grant. In 2004, defense imports declined by $ 0.2 billion but the US Government grant decreased by $ 0.7 billion, falling to $ 2.5 billion. The main reasons for the decrease were the

deferral of domestic uses to 2005 ($ 750 million in defense-grant money is planned for domestic use in 2005; this will also help to improve the current account next year) and less use of the special $ 1 billion defense grant—$ 0.4 billion in 2004 as against $ 0.6 billion in 2003.

The government does most of its borrowing at fixed interest and for long terms; changes in global short-term interest rates do not affect its outlays. However, the decline in global interest rates and the improvement in Israel's standing were reflected in the terms of government borrowing during the year. Thus, the average interest rate on US -guaranteed borrowing in 2004 was 1.7 percent lower than the rate obtained in the previous guarantees arrangement in 1993. After 1999, when the first guarantees arrangement expired, government interest expenditure trended down until 2002 as the government reduced its indebtedness. From 2003 onward, external issues under the current guarantees arrangement caused the government external debt to increase again. Thus far, $ 4.1 billion has been raised and $ 5 billion in further issues is foreseen. The expected borrowing under the guarantees arrangement (which has been extended for three years, to 2008) will evidently boost the government external debt. Thus, the government's external interest payments and current deficit will probably increase in the next few years. Notably, since most government activity in foreign exchange is performed by means of the Bank of Israel, it has no effect on the NIS–forex market.

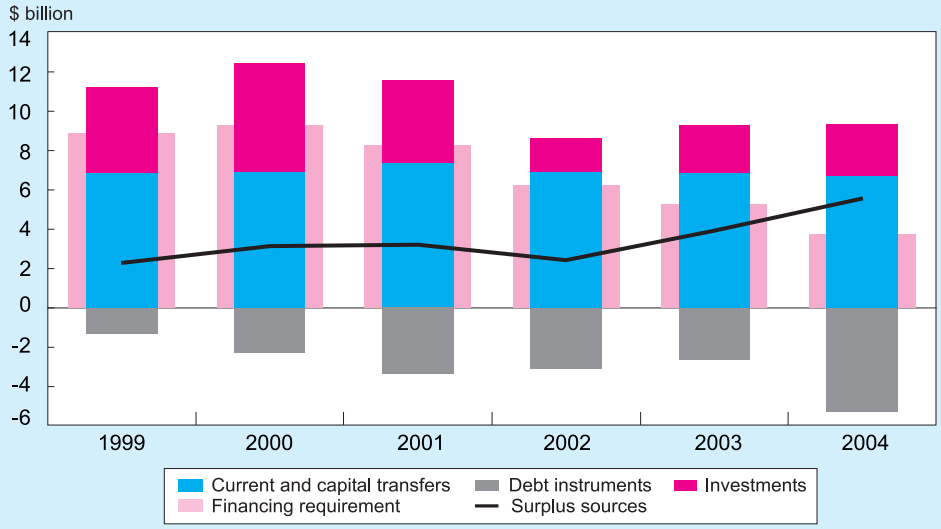
7. DEFICIT ON GOODS, SERVICES, AND FACTOR-INPUTS ACCOUNT

The deficit on goods, services, and factor-inputs account (i.e., the current-account deficit net of current transfers; hereinafter: the deficit) was $ 5.7 billion, almost identical to the 2003 level. However, the deficit in need of financing (the deficit less statistical differentials) was $ 1.6 billion smaller in 2004 than in 2003, at $ 3.7 billion (Table 1.1.3 and Figure 1.2.19) due to an appreciable increase in statistical differentials (see expanded discussion in Chapter 1).[7]

For years, the domestic deficit has been financed mainly by current and capital transfers. In recent years, the economy has had a surplus of nondebt sources—net transfers and investments in capital instruments—at a level similar to that in 2004. Since 2002, current transfers have covered all of the deficit in need of financing, and in 2001 the economy went over from a state of net external debt to a net surplus of debt instruments. In other words, instead of being a net borrower from the rest of the world, Israel became a net lender (see expanded discussion in Chapters 1 and 3).

[7] The deficit in need of financing is not identical to the deficit because statistical differentials, reflecting measurement errors both in the goods, services, and factor-inputs account and in capital movements, are subtracted from the deficit.

Figure 1.2.19
Sources for Financing the Deficit in the Goods, Services and Factor Input Account, 1999–2004



SOURCE: Based on Central Bureau of Statistics data.

8. CURRENT ACCOUNT—INTERNATIONAL COMPARISON

In the past two years, Israel's current-account-deficit/GDP ratio has resembled that of the EU countries.

Comparison of Israel's current account with that of other countries (Figure 2.20) shows that the data for Israel have been improving since 1998. In 1998–2002, Israel's deficit/GDP ratio resembled that of the group of countries that had strong levels of high-tech activity[8] but exceeded the ratio in the EU countries.[9] In the past two years, in contrast, Israel has resembled the EU countries, which in recent years have enjoyed a steady current-account surplus of 0.5 percent of GDP.

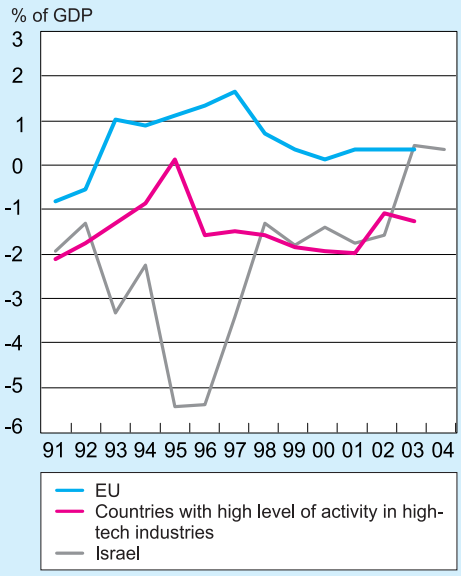
The ratio of the deficit on goods, services, and factor-inputs account to GDP shows a conspicuous gap between Israel and the peer groups until 2003 (Figure 1.2.21). The average rate of deficit in Israel in the past four years (including 2004) was 6 percent as against about 1 percent in the EU countries and 2 percent in the high-tech countries. The past two years stand out from previous years in that the deficit/GDP ratio contracted during this time and neared the level of the high-tech countries. However, Israel has unusual in its level of current transfers from abroad, which, as stated, has exceeded

[8] The peer group is composed of the Czech Republic, Finland, Hungary, Ireland, Slovenia, Slovakia, Sweden, New Zealand, Spain, Italy, and France.

[9] EU countries that outperform Israel in per-capita GDP—Austria, Belgium (incl. Luxembourg), Denmark, France, Germany, the Netherlands, the U.K., Italy, and Spain—were chosen for the comparison.

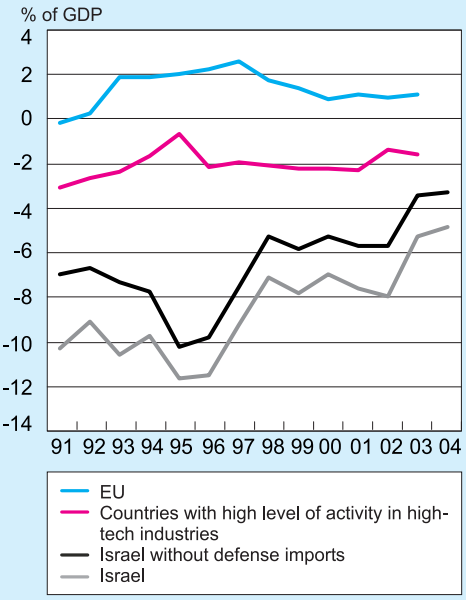
the deficit in need of financing on goods, services, and factor-inputs account in recent years. Israel is also unique in the correspondence between its general-government deficit and its current transfers, since the level of the latter affects defense imports. However, even if defense imports are subtracted from the deficit, Israel's average rate of deficit in terms of GDP during the past four years—4 percent—exceeds that of the peer countries. Just the same, there has been a conspicuous improvement in the past two years, as the deficit ratio approached that of the high-tech countries.

Figure 1.2.20
The Current Account, 1991–2004



SOURCE: Israel — Central Bureau of Statistics; other countries — IMF.

Figure 1.2.21
The Goods, Services and Factor Input Account,[a] 1991–2004



[a] The current account minus net current transfers.

SOURCE: Israel — Central Bureau of Statistics; other countries — IMF.