

Chapter 3

The Financial Account

1. FOREIGN INVESTMENT

a. Main developments

Investment flows in 2004 resembled the 2003 performance in terms of level—\$ 6.6 billion as against \$ 6.0 billion respectively—but not in composition. Net portfolio investment increased by \$ 3.4 billion and came to \$ 5.4 billion; direct investment fell steeply, from \$ 4 billion to \$ 1.6 billion, the lowest level in the past decade, mostly due to an increase in realizations and to a lesser extent by a decline in the investment inflow.

The steep increase in net portfolio investment flows was consistent with global trends, foremost the recovery of the global issues market in high tech but also the continued decrease in global investors' risk aversion. The decline in net direct

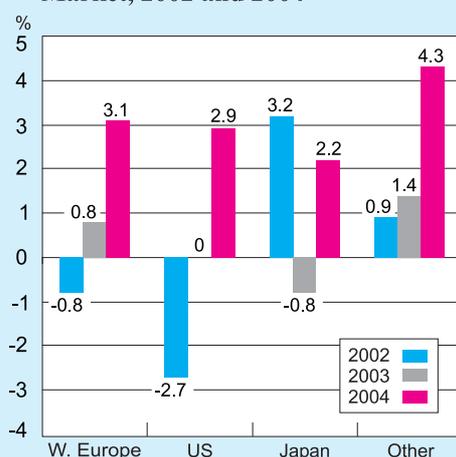
investment, manifested mainly in high-tech companies, was inconsistent with the global trends and, especially, with the continued recovery of demand for high-tech products (Figure 1.3a.1). Net direct investment slipped despite the improvement in domestic macroeconomic fundamentals, including a considerable increase in the real growth rate, solidification and even improvement in the credibility of macroeconomic policy, and the continued decline in country risk due to an improvement in the geopolitical situation, among other factors (Figure 1.3a.1).

Thorough examination of the reasons for the decline in direct investment

Global developments were reflected in a steep upturn in net portfolio investment flows but not in direct investment, which decreased steeply.

The decline in direct investment does not reflect a change in Israel's attractiveness.

Figure 1.3a.1
Growth Rates of Global High-Tech Market, 2002 and 2004



SOURCE: European Information Technology Observatory 2004.

shows that the downturn does not point to a decrease in Israel's attractiveness as a destination of direct investment. Instead, it traces to developments that are actually favorable, some global and some domestic. As some Israeli shares traded abroad commanded high prices during part of the year, foreign investors made large direct sales of shares (\$ 0.5 billion) that had been acquired by portfolio investors. Such an action, by spreading investments in Israeli shares among a larger number of investors, helps to make trading in these shares more efficient. Additionally, in view of privatization processes in the telecommunications industry and as part of a global trend of acquisition of domestic telecom companies by domestic investors, one domestic telecom company bought up \$ 0.7 billion in another domestic telecom company that was held by nonresidents. Direct investments is typified by a small number of large transactions, the timing of which is determined by long-term investment considerations and has to do with domestic and global developments. Accordingly, the trend in direct investment should be examined not only on a calendar basis but also from a long-term perspective. In the last quarter of 2004, nonresidents concluded about \$ 1.8 billion in direct-investment transactions that will be reflected only in the 2005 data. Furthermore, nonresidents are taking part in privatization processes that scheduled to be performed in 2005. Foreign investment in start-up companies and capital raising by

Table 1.3.1
Nonresident Investment, 1999–2004

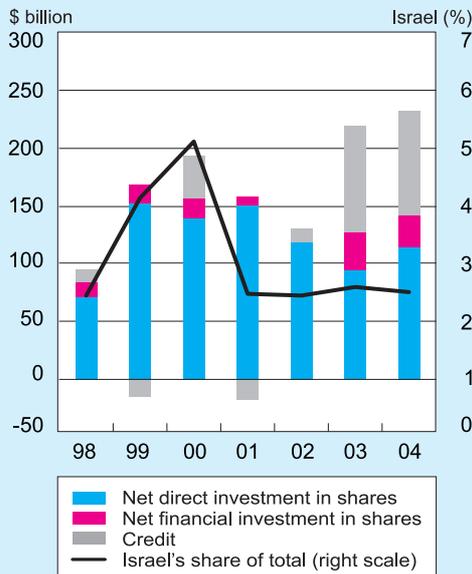
	(\$ billion)							
	1999	2000	2001	2002	2003	2004		
Total investment flows	7.5	11.7	5.3	3.5	6.0	6.6		
Investment by type								
Direct	3.1	5.1	3.6	1.8	4.0	1.6		
Portfolio	2.6	5.1	0.1	0.7	2.0	5.4		
<i>Of which:</i> Shares	1.6	4.4	0.5	0.4	0.4	3.5		
Bonds	1.1	0.6	-0.5	0.3	1.6	1.9		
Other investment ^a	1.8	1.6	1.6	1.0	0.0	-0.4		
Investment by sector								
Nonbanking private sector	4.8	10.2	4.3	3.2	5	7		
<i>Of which:</i> In high-tech	4	9.1	4	2	3	2		
<i>Of which:</i> In shares	4.4	9	4.1	2.2	4	5		
Banking sector	2.4	1.6	1.3	0.1	-0.6	-1		
Public sector	0.3	-0.1	-0.3	0.1	2	1		
							Change in 2004	
	1999	2000	2001	2002	2003	2004	Total ^b	Prices
Balance of investment (end of period)	107	118.1	107.5	104.5	123.5	135	11.6	3.9
Direct investment	19.6	23.8	25	24.8	31.7	33	1.5	0.8
Portfolio investment	44.8	50.5	37.6	32.7	43.3	53	9.8	3.1
Other investment	42.6	43.8	45	47.1	48.5	49	0.3	0

^a Other investment includes deposits with the Israeli banking system and loans to residents.

^b The total change in the balance of investment is made up of investment flows, shown in the upper part of the table, the effect of prices, exchange-rate differentials, and other adjustments not shown here.

SOURCE: Based on reports from banks, companies, and the government.

Figure 1.3a.2
Private Capital Flows to
Emerging Markets and Israel's
Share in Them, 1998–2004



SOURCE: Capital Flows to Emerging Market Economies, Institute of International Finance, January 2004.

Israeli venture-capital funds increased at rates that surpassed those in the U.S. These investments, some of which will only materialize in the future, give an indication of the extent of nonresident investors' confidence in Israel and, especially, in its high-tech industries.

Foreign investment in the nonbanking private sector was \$ 6.6 billion as against \$ 4.6 billion in 2003. This type of investment reflects the degree of foreign investors' confidence in the domestic economy. Most of the increase in portfolio investment in 2004, as in previous years, occurred in securities traded abroad, but net portfolio investment on the Tel Aviv Stock Exchange was also positive for the third straight year, with most of the increase occurring in the fourth quarter. Nonresidents manifested their growing interest in the TASE in both the extent of their activity and

in a significant increase in their share in turnover, consistent with a global trend of greater international-investor activity in the stock exchanges of emerging markets in the past two years. The government raised another \$ 1.1 billion, nearly all under the guarantees arrangement. In contrast, foreign banks and private nonresidents continued to withdraw deposits from the domestic banking system and did so at an accelerating pace, at \$ 1.2 billion in 2004 as against \$ 0.6 billion in 2003. Private nonresidents' net withdrawals came to \$ 0.5 billion for the third straight year. Toward year's end, however, a turnaround came into sight as net nonresident forex depositing with the domestic banking system resumed.

Total foreign investment increased by \$ 11.5 billion during 2004 and came to \$ 135 billion, on the heels of a \$ 19 billion increase in 2003. The effect of prices, which in 2003 contributed \$ 11.5 billion to the increase in the balance, was gentler in 2004, contributing \$ 4 billion to the increase in the balance. Most of the effect of prices occurred in shares traded abroad in the nonresident portfolio, which earned a weighted return of 13 percent in 2004 as against returns of 9 percent and 3 percent on the NASDAQ and NASDAQ high-tech share indices, respectively. Portfolio investments in Tel Aviv, in contrast, gave nonresidents a 20 percent return as against 25 percent on the Maof index. Direct portfolio investment delivered a 13 percent return for nonresidents in Israel and abroad.

Israel maintained its share in private capital flows to emerging markets.

Although Israel maintained its share in private capital flows to emerging markets,¹ at 2.5 percent in 2004 as against 2.6 percent in 2003² (Figure 3.1.2), the composition of these flows is different in Israel than in other countries. The general trend in capital inflow to emerging markets was an increase in direct investment and a decline in portfolio investment; in the Israeli case, as stated, the indicators were reversed. Consequently, Israel's share in the direct-investment flow plummeted from 3.5 percent to 0.6 percent while its share in net portfolio investment climbed dramatically, from 1.2 percent to 12.8 percent.

b. Direct investment

Direct-investment flows contracted perceptibly, mainly due to the influence of the high-tech sector.

Net foreign direct investment—investment in nontraded companies, equity-holders' loans, and equity stakes in corporations traded in Israel and abroad—remained at the end-2003 level of \$ 33 billion, including \$ 23 billion in nontraded companies.

Most of the decrease in net direct investment traced to a perceptible upturn in realizations; investment inflows declined gently.

Net investment flows contracted in 2004 relative to 2003 and came to only \$ 1.6 billion as against \$ 4 billion, respectively. The decrease traced largely to a \$ 1.7 billion upturn in realizations, of which \$ 0.7 billion occurred in one transaction as a domestic telecom company acquired the stake of nonresidents in another firm in the same industry. Direct investors in technology companies took advantage of price levels to realize \$ 0.5 billion in holdings. The investment inflow decreased by \$ 0.7 billion. This, however, attests not to a decline in Israel's attractiveness relative to 2003 but mainly to a disparity between the dates on which transactions were signed and those on which they are to be performed.

Most of the decrease in investment occurred in high-tech, with negligible net investment in 2004 as against \$ 2.6 billion in 2003. Net investment in traditional industries, in contrast, increased by \$ 0.4 billion and came to \$ 1.6 billion (Figure

Table 1.3.2
Direct Investment Nonresident, 1999–2004

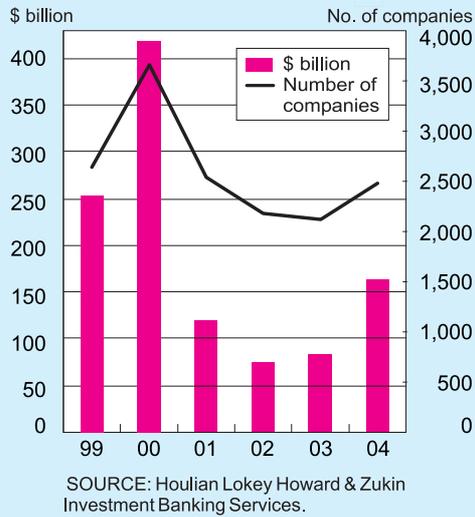
	(\$ billion)					
	1999	2000	2001	2002	2003	2004
Total investment flows	3.1	5.1	3.6	1.8	4	1.6
Investment inflows	5.6	8.3	6.7	4.0	6.3	5.6
Investment outflows	2.5	3.2	3.0	2.2	2.3	4.0
Nontraded companies	2.6	5.4	4.0	1.7	3.1	1.3
<i>Of which: investment in longstanding technological companies</i>	1.4	1.9	1.9	0.5	1.5	-0.3
Start-ups	0.6	1.4	1.3	0.9	0.8	0.9
Undistributed earnings	0.5	1.5	0.6	0.3	0.6	0.5
Equity holders' loans	0.2	0.5	0.1	0.0	0.2	0.1
Traded companies (abroad and on TASE)	0.3	-0.5	-0.5	-0.2	0.4	-0.5
Land	0.2	0.2	0.2	0.2	0.5	0.8

SOURCE: Based on reports from banks, companies, and the government.

¹ Based on a comparison with twenty-nine countries defined as emerging markets.

² Institute of International Finance, *Capital Flows to Emerging Markets*, October 2004.

Figure 1.3a.3
Mergers and Acquisitions of
Global High-Tech Companies,
1999–2003



3.1.4). The 90 percent decline in direct-investment flow stands out especially in view of data pointing to a significant increase in mergers and acquisitions around the world (Figure 3.1.3).

The decline in investment in high-tech industries relative to 2003 does not signal a long-term change in the attractiveness of Israeli companies. Detailed examination of changes in the components of direct investment (below) shows that high-tech investment slumped for two reasons: the timing of performance of several large transactions by a small number of firms and a technical changeover of recording from the direct-investment line to the portfolio-investment line. In contrast, capital raising by venture-capital funds and investments in start-up enterprises

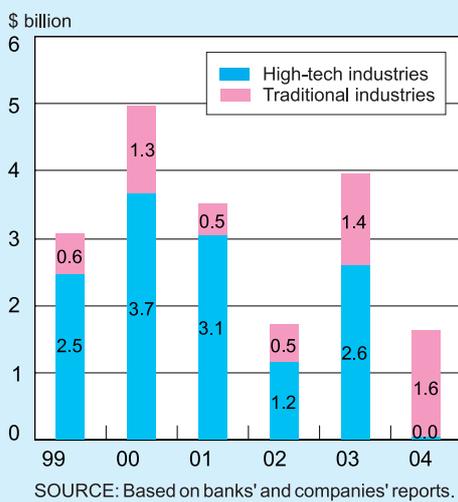
The increase in capital raising by start-up enterprises and venture-capital funds was greater in Israel than in the U.S.

continued to improve in 2004. In fact, the recovery of investment along these two avenues was faster in Israel than in the U.S.

Investment in longstanding technology companies: Nonresidents realized

\$ 0.3 billion in investments in these companies in 2004 after having invested \$ 1.3 billion in 2003 (both figures in net terms). One of the main reasons for the decline was the realization of nonresident investments in one telecom company, tracing to privatization processes in this industry that matured during the year. Additionally, the details of a large acquisition of an Israeli firm by a nonresident investor in 2005 were worked out toward the end of 2004. Three additional transactions of this nature—the acquisition of two Israeli firms and an Israeli bank by nonresidents—were concluded in early January 2005. This backlog of transactions, worth some \$ 1.9 billion

Figure 1.3a.4
Direct Investment Flows, by
Technological Level, 1999–2004



in all, indicates that the decline in direct investment in 2004 does not seem to reflect a long-term change in the patterns of investment, since slight changes in the timing of the transactions would have changed the picture.

Realizations by principals: During the year, principals in a small number of traded technology companies took advantage of the high price levels of the companies' shares to sell some of their holdings to non-principal nonresidents. These realizations, worth \$ 0.5 billion after positive investment of \$ 0.2 billion in 2003, are recorded in the books under portfolio investments.

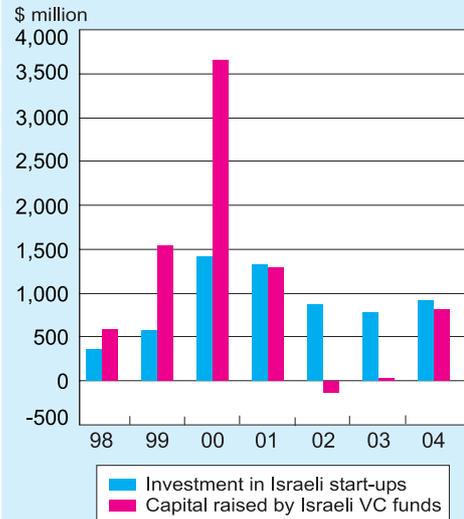
Start-up enterprises: Investment in start-up enterprises and the venture-capital industry, in contrast, climbed from \$ 0.8 billion in 2003 to \$ 0.9 billion in 2004 (13 percent) and recovered to approximately the 2002 level. The current level surpasses the annual average in 1997 and 1998, the years preceding the high-tech bubble, which was particularly conspicuous in this sector (Figure 1.3a.5).

According to various surveys,³ the recovery in capital raising by Israeli venture-capital funds gathered momentum during 2004 and ended the year at \$ 0.8 billion as against a paltry \$ 28 million in 2003 and a negative \$ 145 million in 2002. This level of capital raising, however, still falls short of the \$ 2.2 billion annual average in 1999–2001. The capital stock available to the funds for future investment, most of which was raised from nonresidents, was estimated at \$ 1.8 billion at year's end as against \$ 1.15 billion at the end of 2003. About half of this capital is earmarked for companies that already appear in the funds' portfolios, i.e., for continuing investment; the rest is for investment in new firms. The entire sum is reserved for investment in a range of two to four years. The increase in capital raising by Israeli start-up companies and venture-capital funds in 2004 surpassed the performance of these entities in the U.S. and attests to strong nonresident confidence in the Israeli economy and, in particular, its high tech sector (Figure 1.3a.6).

Reinvested undistributed earnings: Earnings of this type, concentrated in a small number of nontraded high-tech companies, declined from \$ 640 million in 2003 to \$ 530 million in 2004. The decrease was due mainly to nonrecurrent accounting and taxation events, related to Israeli companies' multinational ownership, that affected earnings substantially; it does not reflect a decrease in sales, which actually increased.

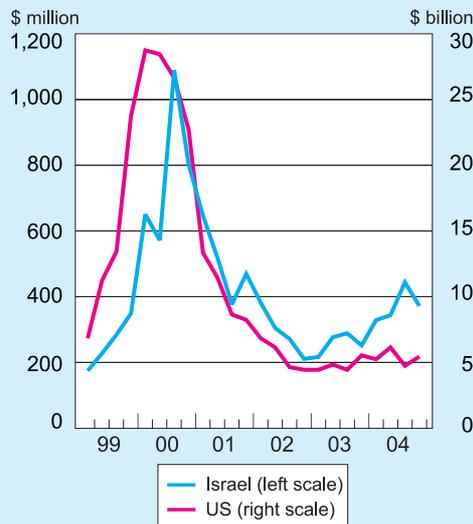
³ For example, by Israel Venture Capital (IVC).

Figure 1.3a.5
Capital Raised by Israeli Venture Capital Funds, and Nonresident Investment in Israeli Start-Ups, 1998–2004



SOURCE: Based on IVC reports.

Figure 1.3a.6
Commitments to Invest in
Start-Ups in Israel and the
US, 1999–2004



SOURCE: The Money Tree Survey, Pricewaterhouse Coopers.

The dominance of high-tech in Israel is a source of severe variance in direct investment, which has been the main path of foreign investment in recent years. The variance is rooted in the concentration of the investment: \$ 8 billion, about one-fourth of the total direct investment, is held in only ten companies, most of which are fully controlled by nonresidents. This makes these companies strongly dependent on three factors: global developments in their areas of activity, the situation of the parent company, and the relatively small number of decision-makers. In contrast, the concentration of most direct investment, \$ 23 billion, in nontraded companies reduces potential vulnerability because these investments are relatively difficult to realize.

A long-term comparison of Israel's direct investment inflow with that of countries that resemble Israel in terms of technological level and per-capita income shows that the gap between Israel and Western European countries in the sample narrowed significantly between 1998 and 2000 due to the global efflorescence of technology industries and Israel's comparative advantage in them. Since 2000, Israel's gap vis-à-vis Western Europe has been widening and the Eastern European countries' gap vis-à-vis Israel has been narrowing. This is evidently due to the combined effect of the global high-tech crisis, the eruption of regional violence in October 2000, and massive investments by the European Union in Eastern Europe ahead of these countries' joining the EU. In contrast, Israel's direct-investment potential resembles that of Western European countries (see Box).

Real-estate investment: Nonresident investment in real estate continued to expand vigorously and came to \$ 0.8 billion in 2004 as against \$ 0.5 billion in 2003 and \$ 0.2 billion in each of the years 1999–2002. The main reason for the uptrend was the investment opportunity occasioned by the protracted decline in the prices of prestige dwellings in Israel (which are acquired mainly by nonresidents). Furthermore, the low interest rates paid on nonresident forex deposits with Israeli banks led in 2004, as in 2003, to the reinvestment of some of these deposits in real estate. Another possible explanation is the upturn in antisemitism in Western Europe, which increased the number of immigrants from that part of the world.

Box 1.3.1**Foreign Direct Investment—Potential and Actual**

In 1998–2004, foreign direct investment (FDI) was \$ 24 billion, 50 percent of total foreign investment. The special interest in FDI in Israel stems from the high share of FDI in total foreign investment and its contribution to GDP, growth via domestic investment, and employment. The importance of examining FDI in the long term originates in its long-term nature, since such investments are less affected than others by short-term factors.

Since 2002, the UN Committee on Trade and Development (UNCTAD) has been publishing two indices that examine how various countries are coping with global competition for FDI. These indices rank the countries by the extent to which they absorb direct investment (“performance index”) and by their potential in attracting direct investment (“potential index”). Since 75 percent of Israel’s FDI focused on high tech during these years, it is of interest to examine where Israel stands among countries that resemble it in technological level and per-capita GDP:¹ Ireland, Portugal, Spain, Italy, France, Hungary, Czech Republic, Slovenia, and Poland (hereinafter: the “sample countries”). The countries rank within +/- six places of Israel in technological achievements and surpass Israel by \$ 2,600 in average per-capita GDP.

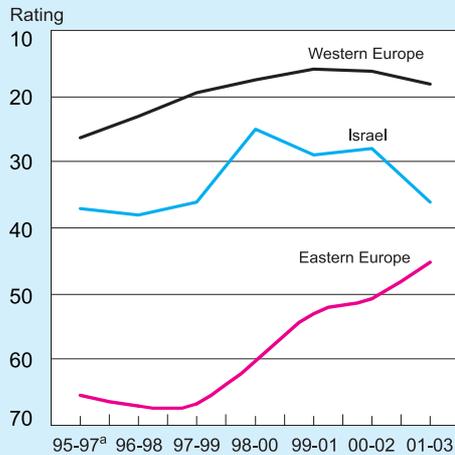
Even though Israel is a small economy with high country risk, its direct-investment potential resembles that of the Western European countries due to its high ratio of R&D to GDP, high growth most of the time, a high rate of exports relative to GDP, and availability of communications and information media. However, actual direct investment (adjusted to country size) is smaller in Israel than in the sample countries due to their concentration in technology industries and Israel’s geopolitical situation.

The scores on the performance index over the past decade, measuring the ratio of each country’s share in total direct-investment inflows to its share in global domestic product, show that the high-tech boom allowed Israel to significantly narrow its performance gap vis-à-vis the countries of Western Europe in 1999–2000. The impact of the global high-tech crisis, coupled with the deterioration of national security in September 2000, lowered Israel’s standing relative to the sample countries² (Figure 1).

¹ Technological-achievements ranking: World Economic Outlook, 2002. Wealth ranking: PPP per-capita GDP, Human Development Report, 2004.

² The decrease in 2001–2003 relative to the previous period was due to the subtraction of 2000 from this period. Since 2000, the Eastern European countries have gained on all sample countries, largely due to investments by the European Union ahead of their joining the Union.

Figure 1
Rating of Countries in Sample by
Performance Index,^a 1995–2003
 (a rise means an improvement)



^a Three-year average.

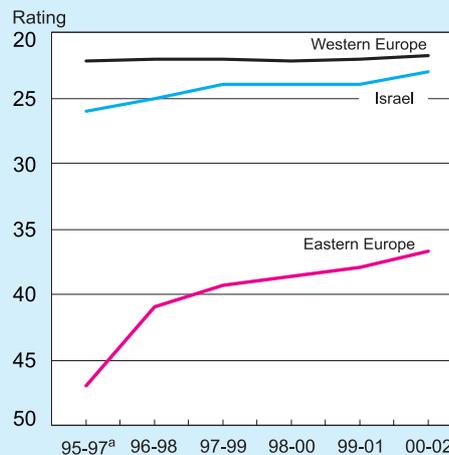
SOURCE: Based on World Investment Report 2004.

students in the population), the existence and availability of communications and information infrastructures (estimated by the average number of land and cellular-phone lines per 1,000 inhabitants and per-capita energy consumption), share in the global production system (proportion of imports of electronic components, exports of natural resources, exports of services, and balance of direct investment relative to the world), and country risk.

Israel's direct-investment potential, according to the components of the index, is limited from the outset due to the advantage that large countries have

The potential index weights twelve structural variables that may affect a country's ability to attract FDI.³ The variables reflect the country's economic profile: its level of economic development (in terms of per-capita GDP and growth over the past ten years), economic openness and competitiveness (the share of exports in domestic product), technological capabilities (the share of R&D expenditure in domestic product), schooling (the proportion of doctoral

Figure 2
Rating of Countries in Sample by
Index of Potential,^a 1995–2003
 (a rise means an improvement)



^a Three-year average.

SOURCE: Based on World Investment Report 2004.

³ Three-year moving average.

over small ones (in one-third of the components) and due to its country risk, which is much higher than that of the sample countries. Despite the inherent downward skew in Israel's rating, in 1995–2002 the gap between Israel's direct-investment potential and that of Western European countries was small and narrowing.⁴ The standings of the Eastern European countries vis-à-vis Israel and Western Europe have been improving steadily due to inexpensive and skilled human resources, unrestricted access to the European market, investment in structural changes, and ongoing privatization (Figure I-2).

Israel derives most of its foreign-investment potential from a rate of R&D expenditure in GDP that is three times that of Eastern and Western Europe. Its long-term uptrend in this regard is helping it to narrow the gap with the Western European countries despite the adverse effects of other components. For example, even though Israel's real GDP growth rate during the three most recent sample periods slowed relative to Western Europe, Israel still gained on these countries in the rating of its investment potential.⁵

Additional components that contributed to Israel's rating were average cellular-phone lines per 1,000 inhabitants, which were 30 percent higher than the sample countries' level, and the share of exports in GDP, which surpassed the Western European average (except for Ireland) by 9 percent of DGP on average. Rapid GDP growth relative to the sample countries also contributed to Israel's consistent high ranking.

⁴ Notably, Ireland gives the ranking of the Western European group a significant upward skew by accounting for 20 percent of the group due to its high rating in all components of the index during the sample years. For example, the average real GDP growth rate the three most recent sample periods stood at 8.1 percent and 2.1 percent in Ireland and the other Western European countries in the sample, respectively, and the proportions of their exports in GDP were 95 percent and 28 percent, respectively.

⁵ Since the yardstick at issue is average GDP growth over ten years, the comparison with the Eastern European group is problematic because these countries had low growth rates in the early 1990s (shortly after the disintegration of the Soviet Union).

c. Portfolio investment

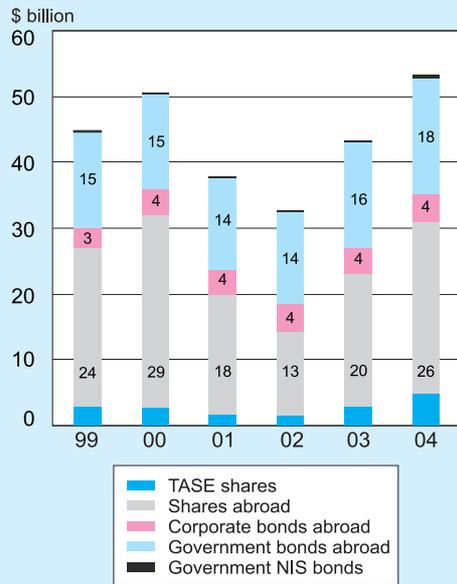
Nonresident portfolio investment is composed of nonresident financial holdings of Israeli corporate shares and bonds (straight and convertible) that are traded on the Tel Aviv Stock Exchange and abroad, and of Israel government bonds. This balance, traded in great part on foreign stock exchanges, increased by \$ 10 billion in 2004 and came to \$ 53 billion (Figure 3.1.7). Net investment flows were \$ 5.4 billion, most of which, \$ 3.9 billion, were invested in the private sector. The remainder was invested

Table 1.3.3
Nonresident Portfolio Investment, 1999–2004

	(\$ billion)					
	1999	2000	2001	2002	2003	2004
Total investment flows	2.6	5.1	0.1	0.7	2.0	5.4
Shares and bonds traded on TASE	-0.1	-0.3	-0.7	-0.2	0.3	0.5
Shares and bonds traded abroad	1.6	4.7	1.3	0.6	0.1	3.0
<i>Of which: Share issues</i>	2.1	3.5	0.7	0.1	1.0	2.8
Corporate bonds traded abroad	1.1	0.7	0.1	0.2	-0.5	0.4
<i>Of which: Bond issues</i>	1.2	1.4	0.8	0.0	-0.5	0.0
Government bonds traded abroad	0.0	0.0	-0.5	-0.1	2.0	1.4
Government bonds traded in Israel	-0.0	-0.1	-0.1	0.2	0.1	0.0

SOURCE: Based on reports from banks, companies, and the government.

Figure 1.3a.7
Balance of Nonresidents' Tradable Portfolio Investment in Israeli Assets, by Site of Trading, 1999–2004



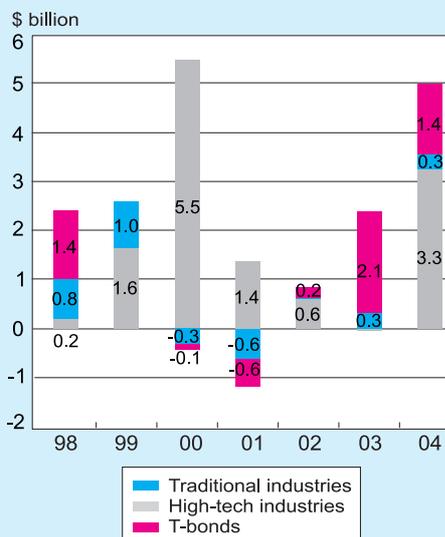
SOURCE: Based on reports from banks, companies, and Ministry of Finance.

Additionally, in 2004 there were realizations of nonresident direct investors' holdings of shares of Israeli firms traded abroad; these investors took advantage of the trends in share prices to sell off some of their holdings, which were bought up by portfolio investors.

in government securities, mostly issued under the U.S. guarantees arrangement (Figure 3.1.8).

The data on financial investments do not include \$ 2.2 billion in issues—twice the 2003 level—by semi-Israeli firms, i.e., firms that foreign investors think of as Israeli even though they are defined as foreign by the balance-of-payments criteria.

Figure 1.3a.8
Nonresident Portfolio Investment Flows, by Technological Level, 1998–2004



SOURCE: Based on reports from companies and banks.

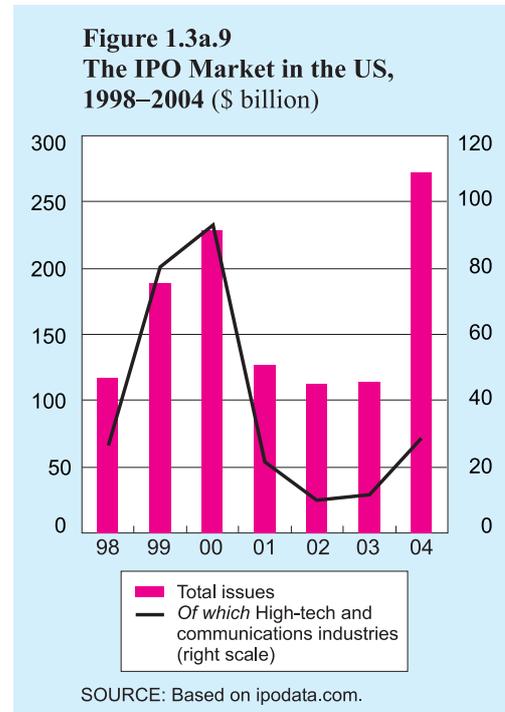
The global recovery, especially in technology industries, was reflected in an increase in Israeli corporate issues abroad.

1. Foreign investment in Israeli shares

The balance of foreign portfolio investment in Israeli shares, traded abroad and in Tel Aviv, increased by \$ 8 billion in 2004 (34 percent) and came to \$ 31 billion. Investment flows were \$ 3.5 billion as against only \$ 0.4 billion in 2003. Rising prices, nearly all of which in high-tech shares traded abroad, added \$ 3 billion to the balance.

The global high-tech recovery continued in 2004. In contrast to the previous year, this recovery was reflected, among other things, in a considerable upturn in corporate issues, especially by high-tech and telecom companies, in international capital markets generally and the American market particularly (Figure 1.3a.9). This abetted a sizable \$ 3.4 billion increase in foreign portfolio investments in 2004, bringing the balance to \$ 5.4 billion by year's end. More than half of the share issues were made by Israeli technology firms abroad, which increased more rapidly than these domestic firms' issues. In 2004, the issuing companies were typically longstanding and profitable ones (unlike those that issued during the "bubble" period).

The balance of foreign investment in Israeli firms' shares traded abroad climbed by \$ 5 billion during 2004 and ended the year at \$ 26 billion. About 70 percent of the balance was related to only two companies. Nonresidents also invested \$ 16 billion in semi-Israeli firms, mainly three. The uptrend in the American issues market, especially in three industries—software, Internet, and telecom—in which many Israeli firms that qualify for issuing operate, was bumpy during the year. In the second quarter, for example, issues by firms in these industries in the U.S. dipped steeply relative to the first quarter, improved in the third quarter, and slumped again at the beginning of the fourth quarter. Thus, companies in the midst of issuing processes encountered windows of opportunity that opened and closed. Young companies that could have easily launched IPOs during the technology bubble years still find it difficult to make this move. All issuing companies in 2004 were longstanding firms that had track records of sales and profitability. For several of them, however, the issues in 2004 were American IPOs. Notably, in I-2004, after a hiatus of several years, three Israeli firms issued on European stock exchanges. Most firms that issue in Europe are small companies that do not meet the threshold requirements for offerings in the American market.



Another trend observed this year was the buy-back of shares by high-tech companies, as part of a global trend of supporting share prices. The companies that bought back their shares were typified by having a large backlog of orders.

American-traded Israeli shares in the nonresident portfolio earned a weighted return of 13 percent in 2004, as against a 9 percent return on the NASDAQ exchange and only 3 percent on the technology-share exchange.

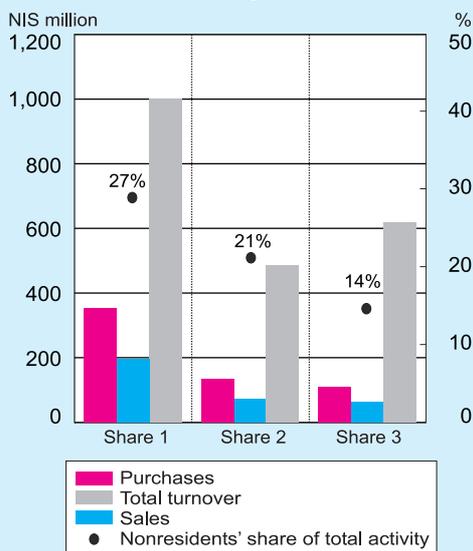
The balance of foreign portfolio investment in securities traded on the Tel Aviv Stock Exchange ended 2004 at \$ 5.2 billion as against \$ 3.4 billion a year earlier. Net investment flows were \$ 520 million—\$ 480 million in shares and the remainder in government bonds (mainly *Shahar*) and Treasury bills. The average nonresident monthly turnover on the Exchange continued to climb, from \$ 1.2 billion in 2003 to \$ 1.8 billion in the year reviewed. The upturn in nonresident interest in the TASE is part of the global trend of greater activity by international investors in emerging markets' stock exchanges in the past two years. Several factors explain the trend: poor yields on risk-free assets, a decline in global investors' risk aversion, and a decrease in risk factors in emerging markets, as reflected, especially in 2004, in an improvement in the country-risk rating of several such economies. Furthermore, most emerging markets are noted today for accelerating economic activity, improvement in financial situation, the implementation of economic reforms, and improvements in political fundamentals.

Nearly all nonresidents who bought shares on the TASE are large financial institutions that have been active in emerging markets. They manage their investments

in reference to an index of similar securities that they use as a benchmark portfolio. The most important index in regard to share investments in emerging markets is the MSCI (Morgan Stanley Capital International) index. Israel is represented in the MSCI by about thirty companies, those in which most investment is made on the NASDAQ exchange, and by a smaller number on the TASE. Accordingly, foreign investment in the TASE is concentrated in a small number of high-volume shares that are not traded abroad. More than 50 percent of the total foreign investment is made in three shares and the proportion of nonresidents in trading in these shares is immense (Figure 1.3a.10). Therefore, even though nonresidents were modestly represented in TASE trading turnover—10 percent

Foreign portfolio investment in securities traded in Tel Aviv increased perceptibly, especially in the fourth quarter.

Figure 1.3a.10
Nonresidents' Turnover in Portfolio of Major Shares, Monthly Average for 2004



SOURCE: Based on bank reports.

on monthly average—they had a substantial impact on the prices of the shares in which they invested and, in turn, had a considerable effect on the entire TA-25 index.

Examination of the proportion of actual investment by funds that invest in shares in emerging-market economies as against Israel's share in the index shows that in 2004, as in 2003, underinvestment in Israel continued at a rate of 1.5 percent. The underinvestment evidently traces to Israel's relatively high share in the index, uncertainty due to the geopolitical fundamentals of the country and the region, and, probably, the “defensive” nature (low beta) of the main Israeli shares in the MSCI index. Thus, when international investors seek high yields on emerging markets' stock exchanges at a time of falling risk aversion, as has occurred in the past two years, Israeli shares in the MSCI index are less attractive than other shares in the index.

2. *Foreign investment in bonds*

Government bonds: Net foreign investment in government bonds traded abroad was \$ 17.6 billion at year's end—\$ 14.8 billion in bonds guaranteed by the U.S. Government and \$ 2.8 billion in non-guaranteed instruments. During the year, the Government of Israel carried out two twenty-year U.S.-guaranteed issues that brought in \$ 1.75 billion (as against \$ 2.4 billion in two issues in 2003). The Government also redeemed \$ 0.7 billion in bonds of this kind and paid \$ 0.6 billion in interest on such bonds. The level of interest payments was affected by the expiration of zero-coupon bonds. Additionally, the Government raised \$ 500 million in a ten-year issue of non-guaranteed bonds.

The yield margin in the issues of U.S.-guaranteed bonds was 30 basis points over U.S. Government bonds of similar term to maturity, as in 2003. In the non-guaranteed issue, which took place in late February, the yield margin over a similar U.S. Government bond was 115 basis points as against 153 basis points in an issue nine months earlier.

The contraction of the margin in 2004 reflects the continuing decline in Israel's country risk. Notably, the decline was smaller in 2004 than in 2003. The decline in margin traced to both domestic and global developments (see the Financial-Stability chapter) that were reflected in the contraction of emerging-market margins by about 50bp during 2004 to 370bp at year's end. Domestic developments that affected the margin included the decrease in geopolitical uncertainty and an upturn in confidence in the conduct of macroeconomic policy (monetary and fiscal), which attested to resolve to carry out the economic reforms amid continued budget restraint. As stated, these developments conflated with global developments that abetted the concurrent narrowing of other emerging markets' margins. The combination of a decrease in perceived global risk and poor yields in developed countries' bond markets prompted investors to seek yields in riskier markets, such as the stock and bond markets of emerging economies. Most of the money went to economies that had falling domestic risk levels and high yields, such as Argentina, Brazil, and Turkey.

In addition to investing in government bonds traded abroad, nonresidents invested in negotiable Israel Government bonds issued in Israel and in Treasury bills. In the past,

Nonresidents' activity in the domestic bond market continued to increase but their share in holdings remains small.

foreign investment in these avenues was insignificant despite the NIS-forex interest spread. In the middle of 2002, however, the large yield spread touched off a wave of acquisitions of Shahar government bonds and Treasury bills, some of which were realized toward the end of 2004. Most investments and activity were concentrated in a small number of foreign-investment banks that invest in their own portfolios in view of their assessments of expected developments in interest rates, yields, and the exchange rate. Treasury bills were usually purchased shortly after issue and were held for one to three months in most cases. In contrast, Shahar bonds were acquired mainly in the secondary market and for varying terms. Despite developments in the field in the past two years, net holdings of NIS-denominated Government bonds and Treasury bills came to slightly over \$ 0.5 billion, less than 1 percent of the total market value of these bonds. Part of the reason for this meager proportion, especially in comparison with other emerging markets, has to do with the depth and liquidity of Israel's bond market. Although the market has developed considerably in recent years, its depth and liquidity still fall short of the emerging-market standard. Implementation of the proposed reform concerning marketing methods in the Israeli bond market, along with the development of a Repo market and the changeover to an RTGS (Real Time Gross Settlement) clearing system, would help to improve liquidity and negotiability. Such developments may boost the share of nonresidents in bonds traded on the Tel Aviv Stock Exchange and in trading turnover.

Although relatively few foreign entities are active on the TASE and despite the large volumes of activity among them, some of which trade in both shares and debt instruments, the correlation between nonresidents' investments in shares and in bonds was found to be low. This illustrates the lack of substitutability among these investment vehicles and shows that the decisions to invest in the various vehicles are made independently of each other.

Corporate bonds: Net foreign holdings of corporate bonds—including convertible bonds issued by Israeli corporations abroad—have hardly changed in recent years. The entire balance, \$ 4.3 billion, was in bonds traded abroad. All issues apart from those in 2000 (when Israeli high-tech companies issued bonds abroad as part of the bubble process) were performed by infrastructure companies and, in large majority, by the Israel Electric Corp., Ltd. (IEC). In 1996–2001, the IEC raised \$ 0.7 billion on annual average in foreign issues. In early 2002, it desisted from this practice due to institutional arrangements that induced it to prefer NIS credit to forex credit. Since then, the IEC has raised capital by issuing CPI-indexed NIS bonds that are sold mainly to domestic institutional investors.

d. Other investments

Other foreign investments are forex and NIS deposits with the domestic banking system and financial and commercial credit from abroad to general government and the nonbanking private sector. The balance of those investments was \$ 49 billion at the end of 2004, largely unchanged from the year-earlier level (Table 1.3.4).

Table 1.3.4
Nonresident Other Investment in Israel, 1999–2004

	(\$ billion)					
	1999	2000	2001	2002	2003	2004
Total investment flows	1.8	1.5	1.6	1.0	0.0	-0.4
Nonresidents' forex deposits	2.6	1.9	0.3	-0.8	-0.7	-0.5
Foreign banks' forex deposits	-0.3	-0.3	1.0	0.9	0.1	-0.6
Credit to private sector	-0.8	-0.1	0.1	0.9	0.7	1.0
Credit to general government	0.3	0.0	0.2	0.0	-0.1	-0.3

SOURCE: Based on reports from banks, companies, and the government.

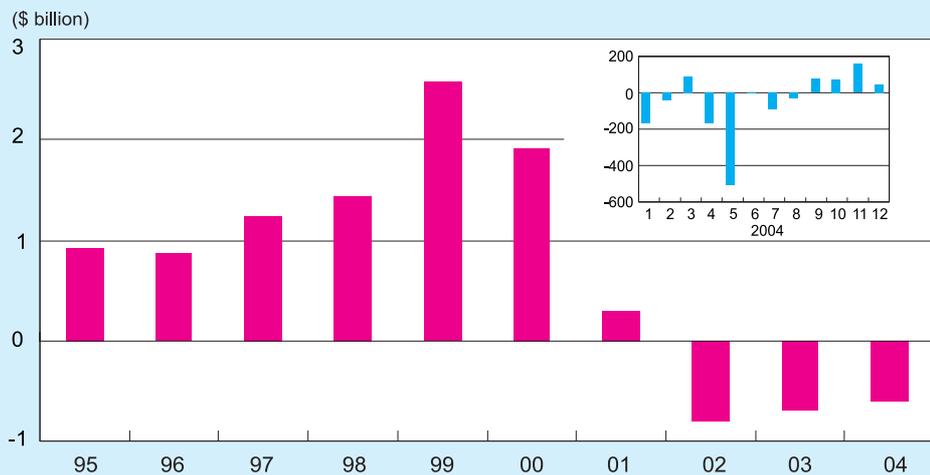
1. Nonresident deposits with Israeli banks

The balance of nonresident deposits (public and banks) was \$ 24 billion at the end of 2004, down by \$ 0.8 billion from the year-earlier level. About 98 percent of the deposits are in forex, the remainder are in NIS. About 80 percent of the forex deposits are for terms not exceeding one year and 70 percent are for no more than three months. Historically, however, these deposits are renewed at time of redemption and are kept for very long terms.

In 1990–2000, nonresident depositing with banks in Israel—excluding deposits of the proceeds of issues by foreign subsidiaries of Israeli banks, which are used to raise long-term forex sources—amounted to about \$ 1 billion on annual average. The trend turned around in 2001: from June of that year to August 2004, nonresidents drew down their forex deposits by \$ 3.7 billion in net terms, including \$ 0.9 billion in the first eight months of 2004 (Figure 1.3a.11). These withdrawals were induced by

In 2004:IV, nonresidents resumed net depositing with the Israeli banking system after forty months of withdrawals.

Figure 1.3a.11
Balance of Nonresidents' Deposits and Withdrawals from Israel's Banking System, 1995–2004^a



^a Inset: monetary data for 2004 (NIS million).

SOURCE: Based on bank and company reports and Ministry of Finance data.

several factors acting in concert. The lengthy decline of international dollar interest rates on short-term deposits (80 percent of the balance of deposits is in dollars), from 6 percent in 2000 to 1 percent in I-2004, gave depositors an incentive to seek alternative low-risk investment channels that would deliver higher returns (e.g., bonds). The deterioration of security since October 2000 prompted nonresidents to transfer funds from domestic banks to others abroad. The Prohibition of Money Laundering Law, which went into effect in 2002, made some depositors jittery about the disclosure of their identity and the nature of their transactions. Thus, the number of nonresident accounts with domestic banks declined by 10 percent in 2002–2004. The trend changed in September, as nonresidents evidently resumed depositing in Israel. The contributing factors to the turnaround were the rate-hiking process in the U.S. and expectations that it would continue, a protracted decrease in the perception of Israel's financial risk, and an improvement in security. The imposition of tax on deposits in Switzerland and Luxembourg may cause some depositors to move deposits to Israel, where deposits of the same type are tax-exempt.

Deposits of foreign subsidiaries of Israeli banks declined by \$ 700 million in 2004 after rising by \$ 100 million in 2003. The decrease traces to an accumulation of surplus forex sources by the Israeli parent companies. The surplus came about due to net repayment of forex credit and rather large-scale net depositing in forex by residents, in view of the narrowing of the interest spread and the decline in exchange-rate risk. Repayment of forex credit by nonresidents and realizations of bond investments abroad furthered the process.

2. External credit to the nonbanking private sector

Outstanding non-tradable credit to the nonbanking private sector (net of equity holders' loans) was \$ 12 billion at the end of 2004, \$ 1.7 billion higher than the year-earlier level. The balance was divided equally between direct credit and suppliers' credit. Some \$ 1.8 billion in direct loans taken this year were offset by \$ 800 million in repayment, with activity concentrated among a small number of companies. Direct credit from foreign banks, which accounted for 45 percent of total direct credit, is highly concentrated—85 percent of the total borrowed by four companies. For the most part, this is long-term credit of a type that cannot be raised from domestic banks. The borrowers—infrastructure and marine shipping companies—hedged the credit risk by acquiring assets that generate forex income. The IEC and other companies that used to need large amounts of credit from abroad—for reasons including difficulty in obtaining long-term, large-scale credit from the domestic system—also raised considerable sums in the domestic market this year. They accomplished this by issuing long-term NIS bonds to domestic institutional investors, taking advantage of the rapid growth of the domestic corporate-bond market.

3. External borrowing by government

Outstanding nontradable forex credit to government was \$ 12.9 billion at year's end, almost unchanged from the year-earlier level. The most important source of credit of

this type is Israel Bonds, which substitute for the issue of negotiable bonds as a way of raising capital. Net capital raised by means of Israel Bonds was \$ 10 billion at the end of 2004. Gross issues declined in 2004 from the record level of \$ 1.5 billion in 2003 to the 2002 level of \$ 1.3 billion. The cost of Israel Bonds issued in 2004 was still 20 basis points higher than that of negotiable Israel Government bonds of a similar term. The decline in issues of Israel Bonds in 2004 was facilitated by other Government issues that were backed by U.S. guarantees. In the past, the Government regularly raised capital from foreign governments, international institutions, and foreign banks as well. Outstanding credit from these sources was \$ 2.8 billion at year's end, \$ 0.3 billion lower than the year-earlier level.

2. RESIDENT EXTERNAL INVESTMENT

a. Main developments

Resident external investment flows continued to climb in 2004 and totaled \$ 9.6 billion.

The balance of resident external investment increased by \$ 11.6 billion (13 percent) during the year and came to \$ 100 billion at year's end. Investment flows were \$ 9.6 billion as against \$ 7.4 billion a year earlier (Tables 1.3.2, 1.3.3), originating in global and domestic factors that affected different subsectors in different ways. Several investment-encouraging factors that had been evident in 2003 intensified this year. Global factors, foremost the continued global high-tech recovery, abetted increases in direct investment and external deposits of the business sector in view of the upturn in high-tech exports and the recovery of the American issues market. The globalization process, in which large companies are taking part, also had an upward effect on direct investments. In contrast, the weakness of the American capital markets and the sluggish global performance of the dollar slowed investments by households and institutional investors in foreign shares and bonds. Domestic factors include the narrowing of the interest spread, which induced repayment of forex credit, and an increase in resident forex deposits, resulting in a surplus of forex sources in the banking system that was deposited abroad.

Direct investment of the business sector increased against the background of the high-tech recovery and continuing integration into globalization processes.

Direct resident external investment was \$ 3 billion, up 25 percent from 2003, and the balance at year's end was \$ 16 billion. Most investment of this type is made by the business sector (Table 1.3.5). The direct-investment behavior of this sector, especially its high-tech component, is influenced mainly by global trends and reflects the sector's efforts to be part of them. This year, in view of the high-tech recovery, several large acquisitions of manufacturing firms were made and several companies that developed in similar directions began to prepare for large acquisitions that will mature in the near future. The global integration of the domestic business sector is reflected in a transition from equity-holders' loans, which were typical of investments in the early 1990s and were meant mostly for the establishment of marketing systems abroad, to capital investments in manufacturing systems.