Chapter 7
The Balance of Payments

- The current account surplus amounted to 1.9 percent of GDP in 2005, more than in 2003 and 2004.
- From the perspective of the last three years, the move to a surplus in the current account reflects mainly an improvement in the goods and services account, despite the deterioration in the terms of trade.
- The export and import growth rates in 2005 were lower than in 2004, although they continued to rise as a proportion of GDP. The slower rate of increase in world trade reduced the expansion in exports, while imports were affected by the lower level of the real exchange rate, the deterioration in the terms of trade and by the slower pace of goods exports, which contain a large component of imported inputs.
- The globalization process is reflected by the range of countries that are Israel's trading partners. The share of the less affluent countries in Israel's exports and imports rose during the last five years. The increased share of these countries, in which labor is relatively inexpensive, was particularly notable in labor-intensive industries although their share in the high-tech industries, which are capital-intensive, also rose.
- The economy's financial account amounted to substantial net capital exports of $6.1 billion due to a large $16.9 billion increase in Israeli resident's investments abroad, which exceeded the $10.8 billion growth in nonresidents' investments in the Israeli economy.
- The growth in Israeli residents' investments mainly derived from institutional investors' more rapid diversification of investments abroad. Another major factor was the repayment of foreign-currency credit by the business sector and an increase in its deposits as the interest rate differential between Israel and abroad contracted, a development that led to the banking system transferring sources to abroad.
- Developments in the financial account were affected by two main processes: government activity and government decisions that were reflected by a record amount of privatization, and by the impact of the structural reforms in taxation and in the capital market; and worldwide financial trends, primarily the rise in short-term yields, which had the effect of increasing Israeli residents' investments abroad, the stable level of long-term yields and the growth in capital movements to the emerging economies, which supported additional capital movements to the economy by foreign residents.

1. MAIN DEVELOPMENTS

In 2005, the current account surplus amounted to 1.9 percent of GDP, greater than in 2003 and 2004.

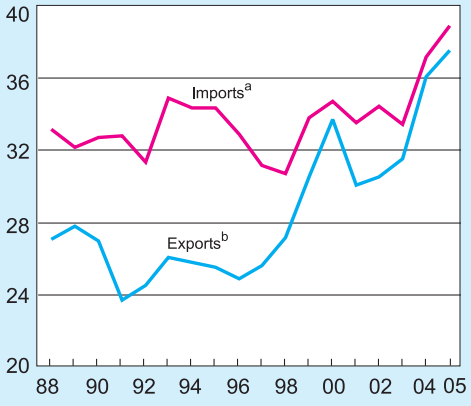
The current account surplus in 2005 amounted to $2.4 billion or 1.9 percent of GDP, an improvement compared with the surplus of 1.6 percent of GDP in 2004 and a smaller surplus in 2003. The improvement in the current account during 2005 reflects a lack of change in the goods and services account resulting from an improvement in the services account and a deterioration in the goods account, and an improvement in the income account that derived from a rise in the interest rates on assets held by Israelis abroad as compared to a smaller growth in the profits of Israeli companies in which nonresidents are invested.

From a long-term perspective, the current account surplus in the last three years denotes a new trend following a deficit that prevailed throughout nearly all the years of Israel's existence.

From a long-term perspective, the current account surplus in the last three years denotes a new trend following a deficit that prevailed throughout nearly all the years of Israel's existence. The move to a surplus in the current account reflects mainly the improvement in the goods and services account, despite a deterioration in the terms of trade: During the last two years the deficit in the goods and services account averaged $0.7 billion dollars a year, compared with an average annual deficit of approximately four and a half billion dollars during 1995-2002. The improvement in the goods and services account deficit resulted from export-oriented growth in 2003 and 2004 concurrent with a continued real depreciation.

From the aspect of saving and investment, the move from a current account deficit to a surplus during the last three years resulted from a continued downturn in the rate of investment in the economy and from volatility in the rates of saving and investment, which was related to the level of activity in the economy during those three years. During the years 2003 to 2005, the ratio of gross investment to GDP averaged only 16.5 percent, which was 6 percentage points less than the average during the second half of the 1990s, while the rate of national saving fell by only 1.5 percentage points. However, an examination of the principal investment components—machinery and equipment, nonresidential buildings, and housing—shows that the level of investment as a percentage of GDP in 2005 was low and that in the long term it is expected to be slightly higher (Box 2.1, Appendix Table 2.17). In comparison with 2004, the growth in the current account surplus in 2005 reflected a 0.9 percentage point increase in the ratio of gross investment to GDP and a slightly larger increase in the rate of saving. The growth in investment reflects an increase in inventories, and

Figure 7.1
Exports and Imports, 1988–2005



[a] Imports of goods and services excluding diamonds.
[b] Exports of goods and services excluding diamonds.

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

Table 7.1
The Balance of Payments, 1995–2005

($ billion)

	1995–1998	1999–2002	2003	2004	2005
(1) The current account	–3.7	–1.5	0.8	1.8	2.4
The goods account	–5.8	–4.1	–3.1	–2.9	-4.0
Goods exports	21.8	28.1	30.1	36.5	39.7
Goods imports	–27.6	–32.2	–33.2	–39.5	–43.8
The services account	-0.3	1.3	1.5	2.2	3.3
Services exports	8.5	12.4	12.7	15.0	16.9
Services imports	–8.9	–11.2	–11.2	–12.8	–13.6
The income account	–3.5	–5.2	–4.0	–3.7	–2.9
Net investment income[a]	–1.5	–2.4	–1.7	–1.7	–0.7
Residents' income[b]	1.8	2.7	2.6	2.7	4.1
Nonresidents' income[c]	–3.3	–5.1	–4.4	–4.4	–4.8
Compensation of employees	–2.0	–2.8	–2.3	–2.0	–2.2
Of which: to foreign workers	–1.6	–2.3	–2.1	–1.9	–2.0
to Palestinians	–0.6	–0.7	–0.3	–0.3	–0.3
Current transfers	6.0	6.6	6.4	6.3	6.0
(2) The capital balance	0.7	0.5	0.5	0.5	0.5
(3) The financial account[d]	2.2	0.9	–2.6	–3.4	–6.1
Direct investments, net	0.6	1.9	1.8	–1.7	3.8
Israelis' investments abroad	–0.9	–1.5	–2.1	–3.4	–2.3
Nonresidents' investments in Israel	1.5	3.4	3.9	1.7	6.1
Portfolio investments	3.1	0.1	–0.8	3.7	–3.1
Israelis' investments abroad	0.1	–2.0	–2.6	–2.1	–7.8
Nonresidents' investments in Israel	3.0	2.1	1.8	5.8	4.7
Other investments, net	2.4	–0.9	–2.5	–5.0	–4.9
Government	–0.2	-0.1	–0.1	–0.2	1.0
Banks	1.1	0.9	–1.8	–4.8	–5.2
Other sectors	1.5	–1.7	-0.6	0.0	–0.7
Financial derivatives	0.1	0.0	0.0	0.0	0.0
Change in the foreign exchange reserves[e]	–3.9	–0.3	–1.1	–0.3	–1.9
(4) Statistical discrepancies	0.7	0.1	1.3	1.0	3.1

[a] Including interest payments and receipts on loans, deposits and bonds, dividends, and undistributed profits.
[b] From investments abroad.
[c] From investments in Israel.
[d] A negative sign indicates capital outflow.
[e] A negative sign indicates a rise in the level of the reserves.
SOURCE: Central Bureau of Statistics.

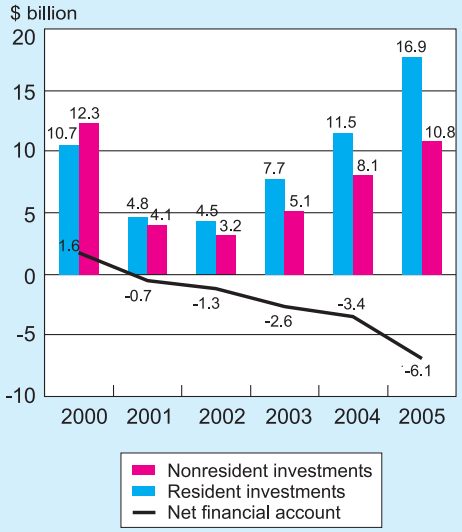
the growth in saving reflects a rise in public saving that was partly offset by a decrease in private saving.

The export and import growth rates in 2005 were lower than in 2004. Exports and imports of goods and services (excluding diamonds) expanded by 6.6 and 5.7 percent respectively in quantitative terms, compared with 19.1 and 11.8 percent in 2004. Despite the decrease, the rates of increase in exports and imports were higher than the GDP growth rate and their proportion to GDP rose (Figure 7.1). The increased proportion of exports in GDP was part of a trend that has lasted for nearly a decade and reflects the development of the economy and its specialization in areas where it enjoys a relative

The export and import growth rates were relatively low this year, though higher than GDP growth, and their share of GDP increased.

advantage. At the beginning of the 1990s, with the onset of mass immigration which spurred domestic demand, the proportion of exports to GDP fell. But in 1988 when the wave of mass immigration ended and the real appreciation ceased, exports began to rise as a percentage of GDP. The increased proportion of imports in GDP during the last two years reflects mainly the greater proportion of fuel imports in GDP resulting from the large rise in their relative price.

Figure 7.2
Nonresident Investments and Resident External Investments, 2000–2005



SOURCE: Central Bureau of Statistics.

The globalization process is reflected by the nature of the countries that are Israel's trading partners. During the last five years, the share of less affluent countries in Israel's overall exports and imports increased.

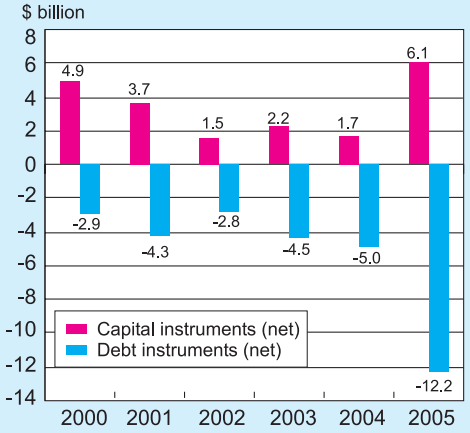
The globalization process is reflected by the nature of the countries that are Israel's trading partners. During the last five years, the share of less affluent countries in Israel's overall exports and imports increased. The increased share of these countries, where labor costs are relatively low, is particularly notable in labor-intensive industries although their share in high-tech, capital-intensive industries also rose. This is because the direct and portfolio investments of foreign investors who wish to benefit from low labor costs in those countries enable them to manufacture capital-intensive products that do not require extensive human capital. As expected however, the growth in imports of high-tech products that are based on human capital from the less affluent countries has been limited.

The growth in Israeli residents' investments mainly resulted from the progress made in removing the barriers to institutional investors' activity abroad. A large increase was recorded in direct investments in the economy, mainly due to the more rapid pace of privatization.

The economy's financial account, which is nonresidents' investments minus Israeli residents' investments abroad, amounted to net capital exports of $6.1 billion. This substantial increase compared with the net capital exports of $3.4 billion in 2004 resulted from the large $16.9 billion expansion in Israeli resident's investments abroad, which exceeded the $10.8 billion growth in nonresidents' investments in the Israeli economy (Figure 7.2). The growth in Israeli residents' investments mainly resulted from the progress made in removing the barriers to institutional investors' activity abroad. Another reason for the growth in investment was the transfer of the banking system's source to abroad. This resulted from the repayment of foreign-currency credit by the business sector and from an increase in its deposits as the interest rate differential between Israel and abroad contracted. Most of the increase was recorded in the private sector's investments in foreign bonds. The level of nonresidents' investments in Israel during 2005 was the highest since 2000. A large increase was recorded in direct investments in the economy, mainly due to the more rapid pace of privatization.

Government activity and decisions again affected the size of the financial account in 2005 as a result of the decrease in the budget deficit, a record amount of privatization,

Figure 7.3
Financial Account (Net) by Instrument of Debt or Capital, 2000–2005



SOURCE: Central Bureau of Statistics.

The financial account was affected principally by government activities and decisions as well as worldwide financial trends.

and the impact of the structural reforms in taxation and in the capital market. The Israeli economy's financial account is also affected by worldwide financial trends, primarily the rise in long-term yields which had the effect of increasing Israeli residents' investments abroad, the stable level of long-term yields and the growth in capital movements to the emerging economies, which supported further capital movements to the economy by foreign residents.

The growth in capital exports in the net financial account reflected the improvement in the current account. A segmentation of the financial account by investment instruments (Figure 7.3) shows that as in the past, net capital imports were recorded in capital instruments (shares—directly and portfolio—and in real estate) and net capital exports in debt instruments (deposits, bonds and credit). The growth in the current account surplus and nonresidents' increased investments in debt instruments was apparent from the increased amount of sources that the business sector transferred to the banks. The banks export these sources abroad as part of their liquidity management, as debt instruments.[1]

Direct investments totaled $3.8 billion compared with realizations of $1.7 billion in 2004. A long-term examination for the years 2000 to 2005 shows that the economy benefited from annual average net direct investments of $1.6 billion, although the volatility from year to year was high. Direct investments are regarded as the preferable form of investment for the economy: they are more productive than other forms of investment; have a high added value for the economy deriving for example from the industrial and managerial know-how brought into the economy via them and they contribute to the expansion of business relations; they are relatively stable, because they are long-term and the ability to withdraw them rapidly is limited; and their investment risks are share with entities abroad.

The average exchange rate of the NIS against the dollar and against the currency basket remained unchanged in 2005, although a depreciation was recorded against the dollar in the second half of the year. One of the causes of the depreciation of the NIS was Israeli residents' tendency to export capital, to an amount exceeding nonresident's demand for investment in the economy. This had the effect of weakening the NIS and

[1] The banking sector does not generally invest in capital instruments. Part of these sources are transferred abroad directly by the non-banking private sector, as capital instruments and as debt instruments.

in the second half of 2005, was more powerful in its impact than the support that the NIS obtained from the current account surplus. See Chapter 4 for a complete analysis of the entire range of factors that affected the exchange rate of the NIS during the period reviewed.

2. THE CURRENT ACCOUNT

The current account, the real exchange rate and the terms of trade

The improvement in the current account during 2005 derived from an improvement in the income account.

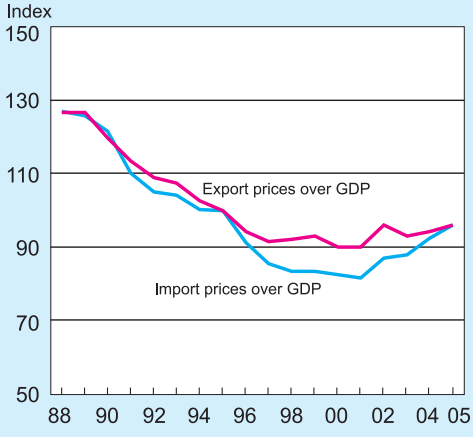
The current account surplus in 2005 amounted to $2.4 billion or 1.9 percent of GDP, an improvement compared with the surplus of 1.6 percent of GDP in 2004 and a smaller surplus in 2003. The goods and services account deficit remained stable in 2005 following two years of improvement that reflected the export-oriented nature of growth during those years. The improvement in the current account during 2005 derived from an improvement in the income account that resulted from a rise in the interest rates on assets held by Israelis abroad, and from a smaller growth in the profits of Israeli companies in which nonresidents are invested.

The rates of increase in both exports and imports slowed in 2005.

The growth in the current account surplus in 2005 concealed a change in the rates of increase in exports and imports and their impact on growth: In 2004, exports (excluding diamonds), which expanded by over 19 percent in quantitative terms, led the growth in business-sector product, and imports (excluding diamonds) rose by 11.8 percent. The rates of increase in both exports and imports slowed in 2005, with exports rising by 6.6 percent, slightly more than the business-sector product growth rate and similar to the pace of expansion in world trade, and imports growing by a more moderate 5.7 percent. The main factors that led to an only moderate upward pressure on imports were the slowdown in exports and especially in goods exports in which imports comprise major inputs, the deterioration in the terms of trade, with its adverse effect on disposable income and the ability to purchase imported goods, and the depreciation in the real exchange rate.

The real exchange rate, under its definition as the ratio between import prices and GDP prices, depreciated in 2005, continuing the trend of the previous three years and had the effect of slowing imports. This was in contrast to the real appreciation trend of approximately 4 percent a year that

Figure 7.4
Real Exchange Rate–Import and Export Prices Relative to GDP Prices, 1988–2005



SOURCE: Based on Central Bureau of Statistics data.

prevailed from the second half of the 1980s and throughout the 1990s. On the basis of export prices, a smaller real depreciation was recorded in 2005 and the level of the real exchange rate remained lower than that at the beginning of the present decade. The real exchange rate, which is defined in terms of the consumer price index as compared to the index in the countries that are Israel's trading partners,[2] showed a similar trend: a depreciation of over 20 percent compared with its level during the years 1995-98 (Table 7.2), of which 2 percentage points were in 2005.[3]

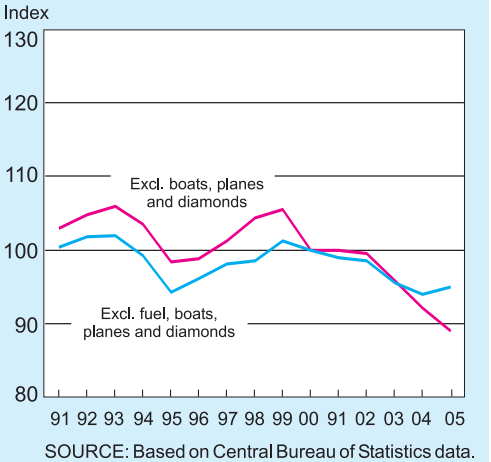
The real exchange rate depreciated in 2005, continuing the trend of the previous three years.

The lower level of the real exchange rate in 2005 compared with the multi-year trend reflects a combination of local and external factors whose main impact is apparent in the short and medium terms. The continued existence of a negative GDP differential throughout 2005 had the effect of slowing the rise in GDP prices relative to the prices of tradable goods. Expansionary monetary policy, which was reflected by a low nominal interest rate, facilitated a nominal depreciation during the year against the dollar and the currency basket, and did not react to the depreciation with excessive interest rate hikes. A real depreciation concurrent with an increase in GDP prices was therefore possible. The deterioration in the terms of trade, which reduced disposable income, also had the effect of leading to a real depreciation.

The lower level of the real exchange rate in 2005 reflects a combination of local and external factors whose main impact is apparent in the short and medium terms.

Another factor contributing to the real depreciation was the reform in the taxation of investments abroad and the expansion of institutional investors' investments in assets abroad. The reform has created a gradual process of adjustment in the public's asset portfolio and an increase in the proportion of the public's asset holdings abroad. Over time, the process of asset portfolio adjustment exerts pressure on the nominal exchange rate, which contributes to a real depreciation. Such an effect on the exchange rate offsets the pressure for a real appreciation – which has continued almost uninterrupted since the mid-1990s – due to the growth in the productivity of the tradable sector

Figure 7.5
Terms of Trade on the Goods Account, 1991–2005



SOURCE: Based on Central Bureau of Statistics data.

[2] The reference is to the ratio between prices abroad, multiplied by the nominal exchange rate, and local prices.

[3] The exceptional increase in fuel prices and raw material prices creates a bias towards a depreciation in the index of the real exchange rate, which is calculated as the ratio between export or import prices and GDP prices, since export and import prices are output prices that are affected by changes in raw material prices, while GDP prices are not affected by these changes. The index of the real exchange rate, which is measured in terms of the consumer price index compared with the index in the countries that are Israel's trading partners, is used to examine relative changes in the price of consumption baskets and is therefore not subject to this disadvantage.

compared with the non-tradable sector and to foreign investors' entry to the economy.[4] In addition to local factors, the increases in the prices of industrial goods that are traded worldwide contributed to the retention of a lower real exchange rate. In dollar terms, these prices rose by 6 percent in 2005 and by an annual average of 10 percent in the last three years, compared with an average annual increase of less than half a percent between the years 1990 and 2002.

The terms of trade in the goods account deteriorated this year. The main source of the deterioration was the worldwide rise in oil prices.

The terms of trade in the goods account, which are defined as the ratio between the prices of exported goods and the prices of imported goods (excluding ships, planes and diamonds), deteriorated by 4 percent in 2005 following a deterioration of the same rate in 2004. The deterioration in the terms of trade during the last two years derived mainly from the worldwide rise in oil prices. Excluding fuels, the terms of trade actually improved by 1.3 percent in 2005. The deterioration in the terms of trade adversely affected real income because of the reduced amount of imports that could be purchased

Table 7.2
Background Conditions to the Balance of Payments—International Trade, the Real Exchange Rate, and the Terms of Trade, 1995–2005

	1995–1998	1999–2002	2003	2004	2005
	(rate of change, percent)				
World trade					
Volume increase, goods and services	7.8	5.3	5.4	10.3	7.0
Volume increase, goods	8.2	5.4	5.6	10.9	7.0
Prices of manufactured goods	–1.6	–2.5	14.4	9.7	6.0
	(nominal rate of change, current dollars)				
Imports from advanced economies					
Low-tech industries	4.4	2.4	13.0	13.8	
Medium-low-tech industries	6.0	2.3	17.8	25.3	
Medium-high-tech industries	8.4	2.9	14.4	17.4	
High-tech industries	10.8	4.8	10.7	18.5	
			(indices)		
Relative prices					
Export prices/GDP prices	104.9	102.5	103.5	104.5	106.7
Import prices/GDP prices	109.3	101.6	106.6	112.1	116.7
Real exchange rate based on the CPI[a]	106.8	104.9	120.9	130.3	132.4
Terms of trade in the goods account[b]	100.5	101.2	95.8	92.1	88.5
Goods export prices[c],[d]	110.0	99.6	100.1	104.1	106.6
Goods import prices[c],[d]	109.4	98.3	104.5	113.0	120.4
Fuel import prices[c]	69.2	85.6	99.9	127.0	175.5

[a] The ratio of prices abroad multiplied by the nominal exchange rate to domestic prices.
[b] Export prices divided by import prices.
[c] Prices in current dollars, year 2000 = 100.
[d] Excluding ships, airplanes and diamonds.
SOURCE: World trade—IMF, World Economic Outlook, October 2005; imports from advanced economies—United States International Trade Commision, OECD-STAN database and Eurostat; relative prices—data of the Central Bureau of Statistics and the IFS (International Financial Statistics of the IMF).

[4] See below, the section on the financial account, for an extensive discussion of Israelis' investments abroad.

at a given level of exports. From the perspective of the last 15 years, the terms of trade were at a particularly low level. Compared with the average terms of trade for the years 1991-2000, the terms of trade in 2005 were down by 14 percent, with the rise in world prices for oil accounting for approximately three quarters of the deterioration.

Exports

In 2005 exports were merely a supporting element of business-sector product growth.

Exports of goods and services (excluding diamonds) rose by 6.6 percent in quantitative terms, similar to the business-sector product growth rate and less than the export growth rate in 2004. While in 2004 exports—especially exports by the high-tech industries and exports of tourism services—led the growth in business-sector product, which was the main source of the rapid growth in aggregate GDP, in 2005 exports were merely a supporting element of business-sector product growth. High-tech industries and services as well as tourism services continued to lead in export growth in 2005. Exports in industries of lower technology did not grow at all (Table 7.3).

A comparison of the growth in exports during the last two years with its expected growth in view of the changes in the relevant long and short-term variables derived from an export equation, shows that the rapid pace of expansion in exports in 2004 did not deviate from the forecast rate derived from the equation, while actual export growth in 2005 was lower than forecast. According to the equation,[5] the principal

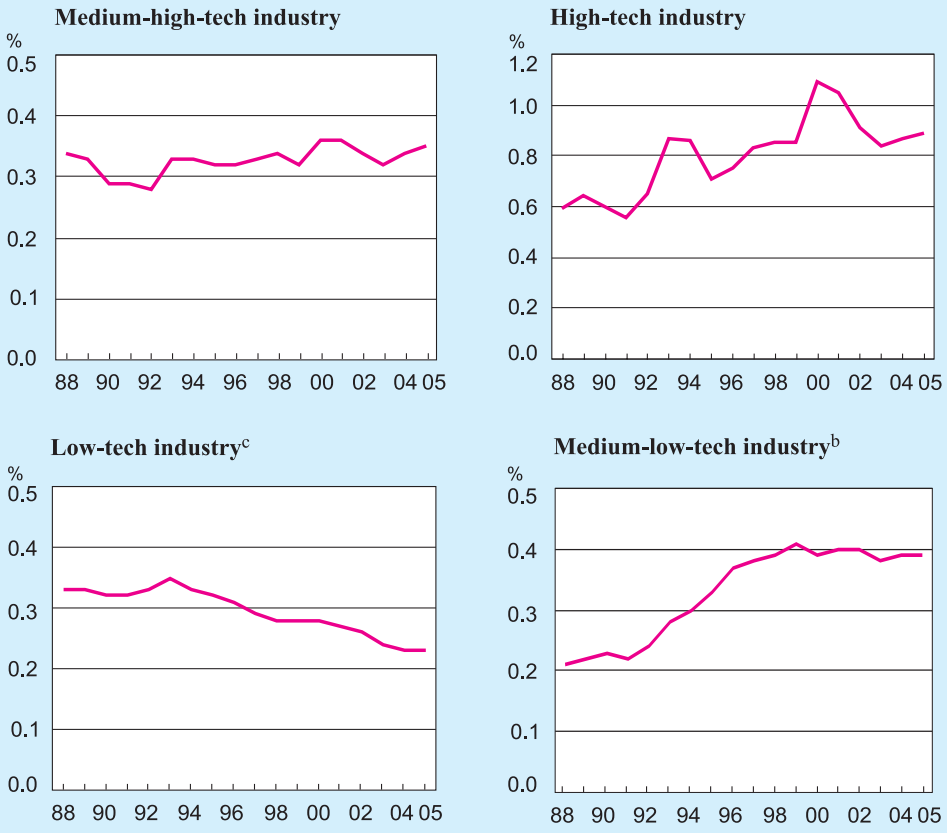
Table 7.3
Goods and Services Exports, 1995–2005

	2005		Volume change (percent)				
	Composition (percent)	$ billion	1995–1998	1999–2002	2003	2004	2005
Goods and services	100	56.6	7.3	4.6	7.3	17.6	4.5
Goods and services excluding diamonds	82	46.5	9.0	3.9	7.5	19.1	6.6
Manufacturing exports (excluding diamonds)[a]	45	25.5	9.1	6.1	3.3	17.6	4.7
High-tech industries	21	11.7	12.0	9.3	0.9	23.1	9.8
Medium high-tech industries	12	6.9	10.6	4.5	3.1	10.3	–0.9
Medium low-tech industries	8	4.7	5.8	3.0	8.9	18.9	0.2
Low-tech industries	4	2.1	–0.9	0.4	3.0	8.9	0.2
Diamond exports	18	10.2	–0.1	8.3	6.4	10.3	–6.1
Services exports	30	16.9	6.7	4.2	13.7	22.5	10.8
Of which: Tourist services[b]	3	1.9	–5.7	–24.9	15.5	35.8	30.2
Other services[c]	18	10.3			14.1	20.6	7.8

[a] Foreign trade data.These data are not consistent with the balance of payments data because in this table they do not include exports to the Palestinian Autonomy and also because of statistical adjustments.
[b] After deducting expenditure in Israel by foreign workers.
[c] According to balance of payments definitions, excluding insurance services and transportation services.
SOURCE: Central Bureau of Statistics.

[5] The export equation is from Y. Lavi and A. Friedman, "The Real Exchange Rate and Israel's Foreign Trade", discussion papers 10, 2005, Research Department, Bank of Israel.

Figure 7.6
Israel's Industrial Exports as a Share of OECD Countries' Imports by Intensity of Technology,[a] 1988–2005



[a] For the period 1988 to 2003, based on data from the STAN database (OECD), including 23 OECD states for which data were available. (For details on which states, see footnote 7). For the years 2004 and 2005, data were based on import figures for US and EU (trade between them and the rest of the world, and trade between themselves).
[b] Excl. mining and quarrying, jewelry, goldsmithing and miscellaneous, according to the OECD definition of mixed traditional industry.
[c] Incl. jewelry, goldsmithing and miscellaneous, according to the OECD definition of mixed traditional industry.

SOURCE: Based on STAN (Structural Analysis) database of the OECD, US trade figures (from the United States International Trade Commission) and Eurostat figures for international trade of the 25 European Union states and Central Bureau of Statistics..

factors supporting exports in 2005 were the improvement in the security situation, the decrease in public consumption and the 7 percent increase in world trade.

High-tech industrial exports have been leading the growth in industrial exports for years.[6] During the last decade, the annual growth rate of these industries amounted to 12 percent compared with only 5 percent with other industrial export components. Accordingly, the proportion of high-tech industrial exports to total industrial exports

[6] Non-diamond industrial exports account for 45 percent of total exports of goods and services, and for 55 percent of total non-diamond exports of goods and services.

rose from 37 percent in 1995 to 45 percent in 2005. The high-tech industries expanded by 9.8 percent in 2005, less than the multi-year average for the last decade.

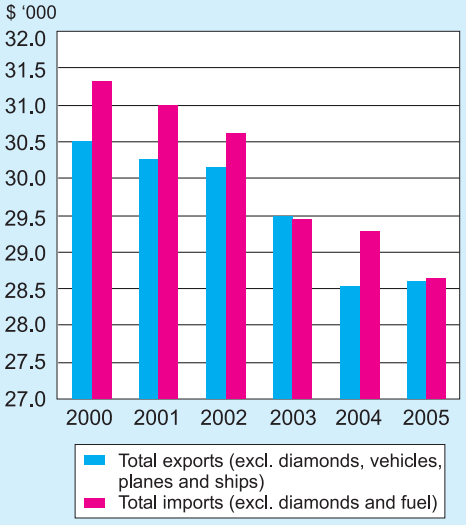
The pharmaceuticals industry's exports led high-tech industrial exports in achieving a growth rate higher than that of business-sector product.

The pharmaceuticals industry's exports led high-tech industrial exports in achieving a growth rate higher than that of business-sector product. During the last decade this industry expanded at a very rapid pace of nearly 25 percent a year and as a result, now accounts for a full 20 percent of exports by the high-tech industries. Excluding pharmaceuticals, exports by the high-tech industries rose by only 3.1 percent.

The past two years have seen a trend in the growing proportion of Israeli exports in international trade in high-tech goods.

Figure 7.6 presents the proportion of Israeli industrial exports by level of technological intensity in OECD countries' parallel imports.[7] The growing proportion of high-tech Israeli exports in international trade in these goods from 1988 to 2005 is apparent from the diagram. The increased proportion of the high-tech industries' exports in OECD countries' imports during 2000-2002 resulted from the opening of the Intel plant in Kiryat Gat, which at the time was innovative, and from buoyant world demand for electronic communications equipment during those years. It can be seen from the diagram that the large 23 percent growth in exports of high-tech goods in 2004 and the slower increase in 2005 match the trends in international trade. The multi-year growth in the proportion of exports of high-tech products in world imports of these goods was thereby maintained during the last two years. [8]

Figure 7.7
Movement of Trade in Exports and Imports of Goods, Weighted Average of Per Capita GDP[a] of Israel's Trading Partners, 2000–2005



[a] Calculated according to per capita GDP for Israel's trading partners since 2004. For further details see Tables 7.4 and 7.6.

SOURCE: Based on Central Bureau of Statistics data.

Israeli exports account for only a few tenths of a percent of world trade. The proportion of Israel's non-diamond industrial exports to OECD countries' total imports in 2005 amounted to slightly more than 0.5 percent, and the proportion of high-tech industrial exports in those countries' imports

[7] Included for the years 1988 to 2003 are the imports of 23 of the 30 OECD member countries: Australia, Iceland, Ireland, Italy, the USA, Belgium, the UK, Germany, Denmark, Holland, Turkey, Greece, Japan, Mexico, Norway, New Zealand, Spain, Portugal, Finland, France, Canada, Sweden and Switzerland. In 2003 these countries' merchandise imports accounted for 65 percent of world imports. For the years 2004 and 2005, the countries' import data were based on the import data of the USA and the European Union (25 countries) after those data had been classified by technological level.

[8] As stated, the comparison for the 2004 and the first half of 2005 was with the imports by technological level of the USA And the 25 European Union countries. In 2004 the total merchandise imports of the USA and the EU countries accounted for 55 percent of world merchandise imports.

reached 0.9 percent. In view of the low proportion of Israeli exports in world trade, it could be claimed that Israeli exporters feel they are faced with a completely flexible world demand curve, and that the sole determinants of the development of exports are local factors. In such a case, world trade as an index of world demand can only be expected to affect the expansion of exports by means of relative prices. This hypothesis is not reflected by actual data: If the hypothesis were correct, we would expect to see relatively high volatility in the proportion of exports in world trade because of frequently changing local background conditions. In practice however and as Figure 7.6 shows, the volatility of Israeli industrial exports in world trade is relatively low, especially in the low-tech and medium-low-tech industries. It can therefore be assumed that the difficulty of gaining a foothold in new markets is the factor behind the relationship between world markets and Israeli exports, particularly in the short and medium terms. The process of entering new markets requires considerable investment and a significant relative advantage. However, an expansion in world demand enables the Israeli exporter to increase the volume of exports in markets where he is a known factor, without the need for the investment necessary for penetrating new markets.

The difficulty of gaining a foothold in new markets is the factor behind the relationship between world markets and Israeli exports, particularly in the short and medium terms.

The globalization process is making it difficult for low-tech export industries to survive. The process is slow and continual, and is reflected by the reduction of customs tariffs, the abolition of quotas, and the gradual transfer of the production of low-tech products to low labor cost developing countries. At the beginning of 2005 for example, the quotas on imports of textile and clothing products to the USA and the European Union were abolished as part of the international trade agreements signed by the World Trade Organization member states.[9] Exports by Israel's low-tech industries hardly changed during the last decade, with the result that their share in world trade declined, especially in the OECD countries' imports. Despite this, in the past two years, the rate of fall in low-tech industries' share in world imports of such goods has slowed.[11] It is reasonable to assume that these developments do not reflect long-term trends, and derive mainly from the real depreciation's support for exports.

Exports by Israel's low-tech industries hardly changed during the last decade, with the result that their share in world trade declined.

The globalization process is reflected by an expansion of world trade and includes a shift of goods production to countries where labor costs are relatively low. The process is also apparent from the shift in Israeli exports to less affluent countries. These countries are expanding their production in order to export to the developed countries, and are increasing their demand for goods in which they lack a relative advantage. Table 7.4 presents the weighted average per capita GDP of Israeli export destination countries, with the per capita GDP of each country weighted in accordance with its share in each industry's exports.[10] The process whereby exports have been redirected to less affluent countries can be deduced from the table. The process is reflected by the decline of the average per capita GDP of Israeli export destination countries between

The globalization process is apparent from the shift in Israeli exports to less affluent countries.

[9] It is difficult to assess the extent to which the abolition of import quotas to the USA and the European Union in 2005 harmed Israeli textile and clothing exporters, because the competition from developing countries for which the quotas were not effective was serious even before the abolition of the quotas.

[10] Based on Israel's exports to 40 countries and those countries' per capita GDP data for 2004. In 2004 exports to countries for which the average per capita GDP was calculated accounted for 93 percent of those exports that are classified by country.

Table 7.4
Goods Exports: Weighted Average GDP per capita, by Destination and Industry, 2000, 2003 and 2005

	Industry share in total goods exports (excluding diamonds)	Weighted average GDP per capita in destination countries[a]			Share of exports by destination in 2005		
	2005	2000	2003	2005	US	EU	East Asia[b]
	(percent)	($ '000)			(percent)		
Total exports (excluding diamonds, vehicles, aircraft and vessels)	96	30.5	29.5	28.6	29	35	12
Machinery, electrical equipment, image and sound equipment and its parts[c]	32	30.7	28.4	27.9	26	28	18
Optical, photographic, medical, measuring and checking instruments	9	32.0	31.6	30.1	35	26	22
Products of the chemical and allied industries	26	26.1	28.3	27.0	32	37	8
Plastic, rubber and articles thereof	7	30.2	29.5	28.8	21	52	2
Base metals and articles thereof	6	31.8	29.9	28.1	27	39	9
Prepared foodstuffs, beverages and tobacco	2	29.5	28.3	29.1	16	55	5
Vegetable products	4	33.2	32.9	32.1	7	79	1
Textiles and textile articles	5	34.8	33.3	33.4	51	30	3

[a] The weighting is determined according to the weight of each country in Israel's total exports and the exports of each industry separately. The calculation is performed on the data of Israel's exports to 40 countries. For most industries that export constituted between 91 percent and 97 percent of Israel's total exports in the years shown in the table. Data of GDP per capita relate to 2004.
[b] China, Hong Kong, India, the Philippines, Singapore, South Korea, Taiwan and Thailand.
[c] Only 86 percent of this industry's exports are sent to the 40 countries from which the GDP per capita is calculated, so that the average GDP per capita for this industry's destination countries may have an upward bias.
SOURCE: Central Bureau of Statistics data. Countries' per capita GDP for 2004 from the United Nations Statistics Division–National Accounts Main Aggregates Database.

2000 and 2005.[11] Particularly notable is the 10 percent drop in average per capita GDP in the export destination countries for the exports of machinery, electrical equipment, picture and sound equipment and its parts, and base metals and articles thereof—two industries where a large proportion of product serves as factors of production for goods whose manufacture has been moved to the developing countries.

The low-tech industries' product that is manufactured in Israel is less labor-intensive than the competing products in the developing countries where labor costs are low, and is distinct from them in terms of quality. These industries' exports—half of which are concentrated in the textile, clothing and leather industry—account for less than 10 percent of total industrial exports. A by-industry examination of the average per capita

[11] For details of export development in past decade by country destination see also Table 7.A.6 in appendix.

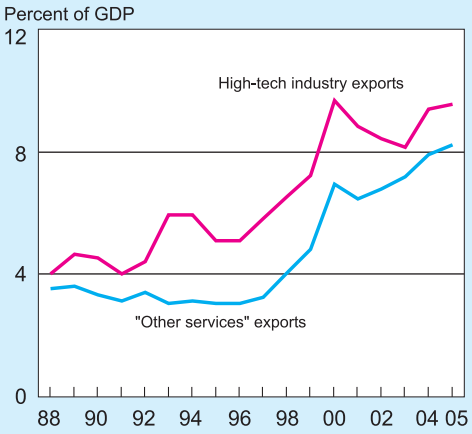
GDP of export destination countries is indicative of the textile industry's uniqueness from the destination countries' aspect—a bias towards the US and a minor proportion to countries with a low per capita GDP. This finding reflects the advantage that the free trade agreement with the US has provided to the Israeli exporter, for quality-demand there, as well as the fact that a considerable part of the product of the textile and textile products industry consists of finished products for which there is no demand in relatively poor countries.

During the last fifteen years, the share of service exports in total exports of goods and services remained practically unchanged, a stability that conceals the change that has occurred in the composition of service exports and their growth potential for the coming years.

Service exports in 2005 totaled $17 billion or 14 percent of GDP. During the last fifteen years, the proportion of service exports in total exports of goods and services remained practically unchanged and in 2005 amounted to 30 percent. This stability conceals the change that occurred during recent years in the composition of service exports and their growth potential for the coming years. During 1995-98, the proportion of tourism service exports amounted to 9 percent of total exports and the proportion of other services' exports, a large component of which are high-tech service exports, amounted to 11 percent. The recession that hit the tourism industry following the outbreak of the intifada reduced the proportion of tourism service exports to total exports to only 2.3 percent in 2002. However, the growth in high-tech service exports as reflected by the increased exports of other services compensated for the downturn in tourism by raising the proportion of other services in exports to 18 percent, and thereby maintained the proportion of total service exports in total exports. In 2005 the proportion of tourism service exports to total exports amounted to only 3.3 percent.[12]

Earnings from tourism (excluding subsistence expenses of foreign workers in Israel) totaled $1.9 billion in 2005. Despite the large increase in the number of tourist arrivals during the year, earnings from tourism were 30 percent less than the average earnings during 1995-98 and 45 percent less than tourism earnings in 1999. (The comparison is in current dollar terms.) This may have resulted from a change in the composition of tourism following the outbreak of the intifada and from its ongoing effect—a decline in the proportion of tourists coming for excursion purposes and a rise in the proportion of those coming for visiting purposes, and who stay at the homes of

Figure 7.8
Exports of High-tech Industry and Other Services,[a] 1988–2005



[a] In 2005 high-tech industry exports accounted for close to 60 percent of total exports of "other services". Given data limitations, export developments of "other services" are used to estimate developments of high-tech industry exports. In 2001-2005, there was no significant change in the weighting of high-tech industry within total exports of "other services".

SOURCE: Based on Central Bureau of Statistics data.

[12] See Table 7.A.8 for details of service exports in current dollar terms, including exports of high-tech services.

friends and relatives. The still low level of tourism earnings is indicative of the growth potential inherent in the tourism industry.

The 'other services' item is the largest in service exports, accounting for 60 percent of the total. This item includes exports of high-tech services such as computer services and research and development, as well as business service exports such as advisory and legal services. The large volume of other services exports that are not well defined and include an extensive basket of services, highlights the difficulty of measuring exports of these services. Since 2004, the Central Bureau of Statistics has published a distribution of other services exports according to the exports' economic industry.[13] This distribution shows that the high-tech industries' exports accounted for nearly 60 percent of total other services exports in 2005. According to these data, high-tech service exports rose by an annual average of 17 percent in current dollar terms during the last two years. A notable development in 2005 was the expansion of high-tech services against the background of the slowdown in the electronics industries' exports. This development may reflect a longer-term phenomenon of a move from exports of high-tech products to exports of high-tech services, which are more human-capital intensive.

Imports

Imports of goods and services (excluding diamonds) rose by 5.7 percent in quantitative terms in 2005 following an 11.8 percent increase in 2004. Excluding fuel and diamonds,

Table 7.5
Goods and Services Imports, 1995–2005

	2005		Volume change (percent)				
	Composition (percent)	$ billion	1995–1998	1999–2002	2003	2004	2005
Goods and services	100	57.4	5.5	5.3	–1.2	12.3	4.2
Goods and services excluding diamonds	84	48.2	6.2	4.0	–2.5	11.8	5.7
Goods	76	43.8	5.1	5.3	–2.2	11.4	3.6
1. Goods (excluding fuel and diamonds)	49	27.8	5.7	3.3	–5.9	12.3	4.8
Consumer goods	9	5.3	7.5	4.9	–6.0	12.2	6.3
Of which: Durables	4	2.3	6.1	2.3	–10.3	18.6	8.4
Production inputs[a]	29	16.8	6.0	1.5	–4.1	14.7	1.9
Investment goods	11	6.2	1.8	7.3	–11.4	10.3	6.3
2. Fuel	12	6.8	6.8	0.0	8.1	–4.2	8.7
3. Diamonds	16	9.2	0.3	14.2	5.9	14.7	–3.3
Services	24	13.6	6.4	5.3	1.6	14.8	5.9

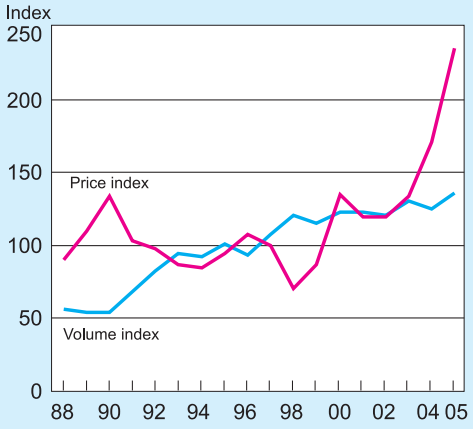
[a] Excluding fuel and diamonds.
SOURCE: Central Bureau of Statistics.

[13] High-tech service exports refer to the exports of the following economic industries: electronic components, electronic communication equipment, control and monitoring equipment, medical and scientific equipment, communications, computer services, and research and development.

Growth in imports of goods and services was low in view of the growth rate in the economy.

imports rose by only 5.2 percent in quantitative terms in 2005, a low rate of increase in view of the growth rate in the economy. An analysis of import developments during 2005 shows that the upturn in imports ceased completely in the course of the year. This was due to the lower level of the real exchange rate and the slower pace of increase in manufacturing exports, where imported products are a major factor of production (Table 7.5).

Figure 7.9
Imports of Fuel, 1988–2005



SOURCE: Based on Central Bureau of Statistics Data.

Fuel imports in 2005 amounted to nearly $7 billion, compared with $4.5 billion in 2004 and $3.7 billion in 2003. The demand for fuels is almost totally rigid, and price changes mainly affect the timing of imports. When fuel prices rose by 30 percent in 2004 for example, an increase that was perceived as temporary, fuel imports fell by 4 percent in quantitative terms. In 2005, even though fuel prices continued to rise, the amount of fuel imported increased by 9 percent (Figure 7.9). In 2005 alone, the increase in fuel prices cost the economy $1.9 billion. If fuel prices in 2003 are taken as a starting point, the cost to the economy of the price increase in 2005 was close to $3 billion.

In 2005 alone, the increase in fuel prices cost the economy $1.9 billion.

The globalization process is reflected in import data as well—a shift in trade to countries with relatively low per capita income.

The globalization process is reflected in import data as well. An analysis of goods imports by country reveals a phenomenon similar to that observed in export data (which were analyzed previously)—a shift in trade to countries with relatively low per capita income. In the case of import data, the shift in trade during the last five years is even more apparent. The shift in imports to countries with relatively low labor costs makes it possible to reduce the price of goods, increases their variety by creating different levels of quality and thereby contributes to well-being. Table 7.6 presents the weighted average per capita GDP of Israel's import source countries by industry.[14] The table shows a 9 percent decrease in the weighted per capita GDP of the import source countries between 2000 and 2005, reflecting the shift in imports from relatively affluent countries to less affluent countries. The shift is particularly notable in the textile and textile articles industry, in which the per capita GDP of Israel's import source countries fell by nearly 20 percent in the last five years. The shift of trade to less affluent countries is also apparent in more technology-intensive and capital-intensive industries such as "machinery, electrical equipment, picture and sound producers and the similar". This phenomenon matches the shift in Israel's exports in this industry, since Israeli goods

The shift is particularly notable in the textile industry.

[14] The weighting of per capita GDP is calculated according to the countries' proportion in total non-diamond merchandise imports and in imports by selected industries, on the basis of per capita GDP in 2002. The calculation is based on imports from 40 countries, which in 2004 accounted for 97 percent of imports classified by country.

Table 7.6
Goods Imports: Weighted Average GDP per capita, by Country of Origin and Industry, 2000, 2003 and 2005

	Industry share in total goods imports (excluding diamonds)	Weighted average GDP per capita in countries of origin of imports[a]			Countries' share of total Israeli imports by industry in 2005		
	2005	2000	2003	2005	US	EU	China
	(percent)	($ '000)			(percent)		
Total imports (excluding diamonds and fuel)	83	31.3	29.4	28.6	17	44	6
Machinery, electrical equipment, image and sound equipment and its parts	26	33.5	32.0	30.5	26	44	6
Optical, photographic, medical, measuring and checking instruments	4	35.5	34.8	34.9	35	43	3
Vehicles, aircraft, vessels, and transport equipment	9	31.7	28.9	29.9	11	48	1
Products of the chemical and allied industries	10	34.2	33.3	31.1	12	57	6
Plastic, rubber and articles there of	5	29.9	28.5	26.9	14	50	5
Base metals and and articles thereof	7	26.4	24.4	23.3	16	37	5
Prepared foodstuffs, beverages and tobacco	3	32.9	31.8	31.2	14	61	1
Textiles and textile articles	4	21.4	17.9	16.9	5	30	26

[a] The weighting is determined according to the weight of each country in Israel's total imports (excluding diamonds) and the imports of each industry separately. The calculation is performed on the data of Israel's imports from 40 countries. For most industries those imports constituted between 95 percent and 97 percent of Israel's total imports in the years shown in the table. Data of GDP per capita relate to 2004.
SOURCE: Central Bureau of Statistics data. Countries' GDP per capita for 2004 from the United Nations Statistics Division– National Accounts Main Aggregates Database.

also serve as production factors or intermediates for the manufacture of such high-tech durables as computers and mobile telephones, the production of which has shifted to countries with relatively low labor cost. The shift of imports to less affluent countries has been possible due to the establishment of international brand manufacturers' plants in those countries. The most prominent country to which imports were shifted during the last two years is China. In 2005 China was third after the USA and Germany in terms of non-diamond goods import volume to Israel. This was only two years after China had ranked in seventh place, after the UK, Italy and France. Particularly notable as regards imports from China in 2005 was the textile industry, as well as machinery, electrical equipment, image and sound equipment and its parts in which the proportion of imports from China is no less than China's overall share of imports.

The most prominent country to which imports have shifted during the last two years is China.

The income account (labor and capital)

The income account includes the economy's receipts from and payments to the factors of production—capital and labor. Between 1993 and 2002, the number of foreign workers in Israel rose considerably and the economy's expenditures on wages rose as

The number of foreign workers in Israel did not change materially in 2005. Expenditure on the wages of non-Israelis totaled $2.3 billion.

a result. These expenditures peaked in 2000 when they totaled $3.2 billion.[15] In 2003 the government applied a policy of reducing the number of foreign workers. This policy led to a 20 percent decrease in their number and a drop in expenditures on the labor of nonresident salaried employees in Israel. The number of foreign workers in Israel did not change materially in 2005, and the number of Palestinians laborers rose slightly. Expenditures on the wages of non-Israelis totaled $2.3 billion.

The transfer abroad of over half of foreign workers' income distinguishes them from Palestinian workers with respect to their effect on the current account.

Foreign workers use 45 percent of their income from labor for subsistence expenses in Israel. Since this part of the expenditures on wage payments for foreign workers is offset by the export of the services that they consume for subsistence purposes in Israel, their net impact on the current account in 2005 amounted to $1.1 billion. The transfer abroad of over half of foreign workers' income distinguishes them from Palestinian workers with respect to their effect on the current account. Because of the proximity of Palestinian workers' domicile to Israel and the close connection between the Israeli economy and the Palestinian economy, most of the Palestinians' remuneration for their labor eventually flows into markets in Israel.

Net payments as remuneration for capital totaled only $0.7 billion.

Net payments as remuneration for capital decreased by a billion dollars to only $0.7 billion. The decrease in payments to abroad in return for capital during 2005 was an important contributory factor to the improvement in the current account surplus. The decrease in these net payments reflects an increase of over a billion dollars in Israeli residents' income from investments abroad, an increase of nearly $300 million in earnings on the foreign exchange reserves and an only moderate increase of less than half a billion dollars in nonresidents' income from their investments in Israel.

Although the decrease in payments for capital partly derived from a rise in interest rates abroad, this alone cannot explain all of the change in the income account. The Israeli economy became a net lender in recent years: The balance of assets held by Israeli residents in the form of debt instruments (deposits and bonds) exceeds the balance of debt instruments held by nonresidents. Since a rise in the interest rate supports an increase in net income from debt instruments, Israeli residents holding a surplus of debt instruments benefit from such an increase.

The transformation of the economy into a net lender is a result of nonresidents' extensive investments in Israel during recent years, mainly in capital instruments.

The transformation of the economy into a net lender is a result of nonresidents' extensive investments in Israel during recent years, mainly in capital instruments––shares of Israeli companies. The balance of nonresidents' investments in capital instruments amounted to $77 billion at the end of 2005, while the balance of Israeli residents' holdings in capital instruments abroad was only $20 billion. The ownership of Israeli companies is expected to yield income for Israeli residents at a time of growth - when the companies' profitability is high and dividends are distributed. Despite the rapid growth and increase in profitability during 2005, nonresidents' dividend income from the holdings in shares of Israeli companies did not rise and nor did their income from undistributed profits—profits of companies owned by nonresidents, that are reinvested in Israel.

[15] Including expenditures on Palestinian labor.

Current transfers

Current transfers in 2005 totaled 4.9 percent of GDP compared to 5.4 percent in 2004. The volume of current transfers during the last two years was between half a percent and one percent of GDP less than in the previous ten years. The decrease in current transfers in GDP percentage terms may be indicative of a resumption of the downtrend in their volume that followed the 1985 economic stabilization program, and which ceased in the second half of the 1990s.

Current transfers in 2005 totaled 4.9 percent of GDP compared to 5.4 percent in 2004.

The decrease in current transfers derives from a reduction in direct US government aid to Israel, which amounted to 1.9 percent of GDP in 2005. However, net current transfers to the private sector remained stable and amounted to 2.2 percent of GDP.

By international standards, the volume of current transfers to Israel is high. There are four sources of current transfers: US government aid, reparations from Germany, donations to institutions such as universities and hospitals, and private transfers. US government aid had been decreasing continually and in 2007 is expected to level off at $2.4 billion. In 2005 US government aid and reparations from Germany accounted for 40 percent and 12 percent of total net transfers respectively. Net transfers to individuals during the last five years ranged without any discernible trend around 2.1 percent of GDP, slightly less than the level prevailing at the time of the mass immigration from the former Soviet Union when the net transfers of the private sector amounted to over 2.5 percent of GDP.

3. THE FINANCIAL ACCOUNT

a. Main developments

A number of processes can be distinguished in 2005, both local and global, each of which influenced a number of the components of the financial account. The most significant local factor was the activity of the government while the most dominant global factors were the changes in short-term yields together with relative stability in long-term yields and capital flows to emerging economies.

Activity of the government: This year government activity continued to have a major influence on the economy's financial account. This represented a continuation of the trend which began in 2002 in reaction to the deterioration in the economy. Underlying the process were the contraction in the involvement of the government in financial markets (including the reduction in the budget deficit and the sale of government-owned companies) and the implementation of measures to improve the functioning of those markets (such as the elimination of distortions in taxation and the allocation of investment). The effects were felt this year in various components of the financial account and through a number of channels.

The government this year continued to reduce its fiscal deficit. Its success in doing so enabled it to reduce its efforts to finance the deficit both in Israel and abroad[16] and to reduce the cost of financing its debt. The reduction in the supply of government bonds, including the issue of designated bonds, was one of the factors that induced institutional investors to invest in foreign assets abroad and also contributed to the boom in the issue of corporate bonds and shares on the Tel Aviv Stock Exchange. The accelerated program of privatization (see below) also contributed to the significant reduction in the financing needed for the government deficit.

As part of its privatization plans, in 2005 the government sold the controlling interest in companies worth about $1.9 billion.

The privatization of government companies reached a record high in 2005. In contrast to previous years, in which the privatization process made little progress, this year the government sold the controlling interests of companies worth about $1.9 billion. Nonresidents played a significant part in the privatizations through the purchase of controlling interests in a large communication company and a bank for $1.7 billion and the agreement to purchase an additional bank for $0.2 billion.

The government also influenced the financial account through various structural reforms which have been implemented in recent years. The equalization of tax rates on foreign assets, which was aimed at eliminating distortions in the allocation of investment, led to a large increase in investment abroad by residents, including institutional investors. In addition, the reduction of corporate tax rates increased the attractiveness of direct investment in the economy for nonresidents. The separation of provident funds and study funds from the banking sector led to increased interest in the economy among nonresidents.

Global economic trends:[17] A number of global and local economic trends had a substantial effect on the economy this year. These included the large US current deficit, the increase in the rates of interest and short-term yields, stability in long-term yields and the continuing flow of capital to emerging economies.

The global economy continued to grow in 2005 at a relatively high rate, simultaneous with the growth in the US current account deficit which was consistently financed by private and public capital flows to the US. The activity in the global financial markets was heavily influenced by this development.

The continuing surplus in Israel's current account—reflected by capital outflows––was supported by the trend in the US current account deficit and the growth of technological sectors abroad. These conditions benefited the exports of Israeli companies in the hi-tech sectors whose profits this year were partly due to the increase in exports. It is possible that these positive conditions also contributed to the increase in direct investment in Israel and in Israeli shares in secondary markets abroad. Despite this improvement, there was an overall slowdown in the issues of hi-tech companies on the NASDAQ market, particularly among companies with relatively small market values which include most Israeli companies.

[16] The decline in the government deficit also affected savings, investment, and the real interest rate (see Chapter 2).

[17] Findings of a survey of international developments based on Global Financial Stability, WEO Report, September 2005.

In the global financial markets long-term yields remained surprisingly low[18] while short-term interest rates and yields continued to rise. The low level of long-term yields was one of the main factors underlying the continuing flow of capital to emerging economies, including that of Israel. The stability in long-term yields also moderated the flow of investment abroad from institutional investors as a result of the fear of capital losses when these yields do increase.

In the global financial markets, long-term yields remained surprisingly low and encouraged continuing investments in the emerging market economies.

The global increase in short-term interest rates and the even more rapid increase in short-term yields affected the financial account through a number of channels and in opposing directions. Thus, among nonresidents, short-run yields led to a slowing of capital flows to emerging economies, including that of Israel, in mid-2005. The increase in rates of interest worked in the opposite direction to moderate the withdrawals from nonresidents' deposits in Israel. Among residents, the increase in short-term yields encouraged Israeli institutional investors to increase their investment in short-term bonds abroad and—together with the decrease in interest rates in Israel—reduced the interest rate spread relative to rates abroad. Finally, the reduction in spread induced the business sector to redeem foreign currency bank credit and the banks directed these surplus funds abroad. The increased spread between short-term bond yields and the interest rates on short-term deposits led to a shift of business sector investment abroad from deposits to bonds and the increased investment in bonds by the banks and institutional investors.

The increase in short-term yields encouraged Israeli institutional investors to increase their investment in short-term bonds abroad.

The trend in financial investment in emerging markets strengthened in 2005 but was not uniform throughout the year. The favorable conditions attracting investment to the emerging economies included an improvement in their basic economic results due to the increase in the prices of raw materials which they export, fiscal improvement and improvements in their credit ratings. Among the external factors that encouraged this investment were low long-term interest rates in the US, the increasing presence of foreign strategic long-term investors and the continuing "search for yield". In mid-2005, there was a temporary lull in the flow of investment to emerging economies which was the result of expectations of an increase in long-term yields in the US, the increase in oil prices and the expectations of an end to growth in these economies.

The trends in investment in emerging economies could also be seen in the volume and timing of investment on the Tel Aviv Stock Exchange, though to a lesser degree.

b. Investment by nonresidents in the economy

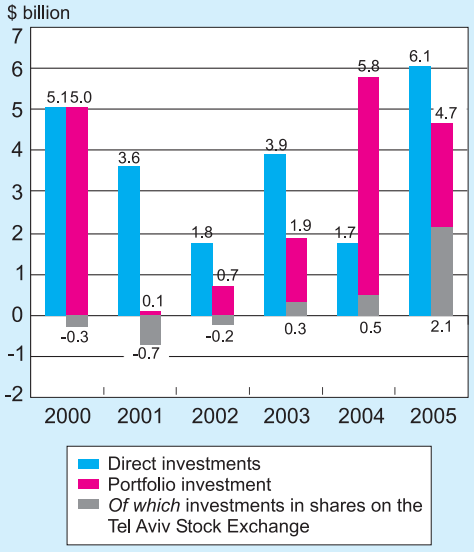
A substantial increase was recorded in direct investment which was offset to some extent by the drop in issues of Israeli shares abroad.

The investment by nonresidents in shares, bonds, real estate, credit and deposits (Figure 7.10) totaled some $10.8 billion this year compared to $8.1 billion the previous year. This was their highest level since 2000. A substantial increase was recorded in direct investment which was offset to some extent by the drop in issues of Israeli

[18] The "riddle of low interest rates" occupied the minds of many economists this year. Thus, despite expectations, the increase in short-term interest rates and of the twin deficits in the US did not lead to a rise in US long-term interest rates.

shares abroad. The increase in direct investment was primarily the result of the accelerated privatization program.[19] Global factors, particularly the flow of capital to emerging economies, shifted a significant amount of investment to the economy, primarily in the form of shares in the trading portfolio on the Tel Aviv Stock Exchange. The increase in investment was also due to the improvement in the economy's real performance and this was reflected in the improvement in the performance of firms and in their balance sheets. The withdrawal of deposits by nonresidents from banks in Israel, which began in 2002, came to a halt this year. The slowdown in the issue of Israeli shares abroad was primarily the result of developments external to the economy, primarily in the US.

Figure 7.10
Nonresidents' Investments in Israel, Direct and Portfolio, (including on Stock Market)



SOURCE: Central Bureau of Statistics.

As in previous years, the lion's share of direct investment and investment in the trading portfolio was recorded in the high-tech sectors.

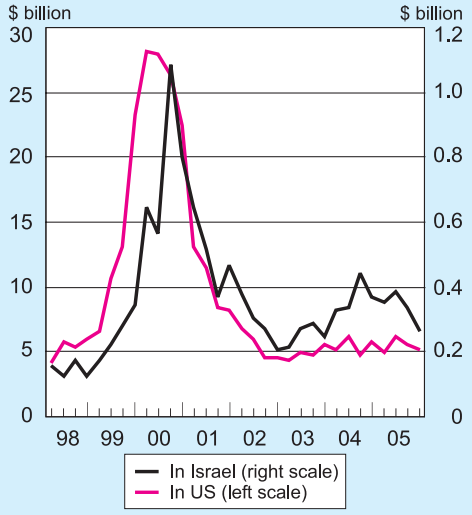
This year, there was a certain amount of shifting of investment between sectors of the economy. As in previous years, the lion's share of direct investment and investment in the trading portfolio was recorded in the high-tech sectors (in the amount of $4.3 billion). However, as a result of privatization, the share of investment in the banks within the trading portfolio grew to $1.2 billion.

The direct investment in the economy by nonresidents grew significantly this year to $6.1 billion (of which $1 billion resulted from privatization) as compared to $1.7 billion in 2004 (Figure 7.10). We would point out that these direct investments create volatility in this category of investment since these are large discrete investments.

Within direct investment there are also components that are characterized by a high degree of stability—a large number of transactions with similar characteristics such as the investment in startup companies and real estate—and the accumulation of profits in Israel. The direct investment in startup companies totaled some $800 million this year which was similar to the amount invested last year. The rate of investment has been stable in recent years and is considered to be high relative to the rest of the world. The amount of capital available for investment—which is the volume of investment committed to by fund investors and which is an indicator of the extent of interest in the

[19] The privatization program has a number of effects which increase efficiency and competition. Here we relate only to the effects of the program on the capital flows into the economy as a result of the participation of nonresidents. This contributes substantially to the economy's efficiency and competition since it is direct investment with all its accompanying benefits.

Figure 7.11
Investment Commitments in Startups in Israel and the US, 1999–2005



SOURCE: The Money Tree Survey, Pricewaterhouse Coopers.

economy and of expected investment in the future—currently stands at $1.1 billion. This level is low relative to past years but has been stable for a long period (Figure 7.11). The sectors in which most of the investment has been concentrated are communication, software and life sciences. Figure 7.11 shows a high correlation between the extent of commitment by venture capital funds to invest in startup companies in the US and the extent of commitment by such funds to invest in startup companies in Israel.[20]

There is a high correlation between the extent of commitment by venture capital funds to invest in startup companies in the US and the extent of commitment by such funds to invest in startup companies in Israel.

The investment in real estate in Israel continued this year at a high rate ($1.2 billion) which is somewhat higher than in 2004. The current rate of investment is significantly higher than two years ago (some $200 million per year).

The growth in direct investment this year was part of a long-run upward trend which has also been observed in other emerging economies.[21] The ratio of direct investment in Israel to that in emerging economies[22] is about 2 percent but this figure fluctuates widely (Figure 7.12). In 2005, this ratio was close to the long-term average of 2 percent. A different comparison[23] indicates that the level of direct investment in the economy is low relative to countries with a similar per capita GDP and a similar level of technological development (Figure 7.13).

The investment of nonresidents in the tradable portfolio continued this year at a high rate and totaled some $4.7 billion though this represented a reduction from the level

[20] An analysis showed that the extent of commitment to invest in startup companies in Israel is influenced primarily by changes in the NASDAQ index, by changes in the volume of mergers and acquisitions in the US and by growth in Israel.

[21] According to the World Investment Report 2005, there was a substantial recovery in direct investment in emerging economies in 2004 following three years of contraction. This was at the expense of investment in the developed countries. The main factors behind this phenomenon were the desire to penetrate new markets as a growth engine for firms in a competitive market and the attractiveness of investment in countries with natural resources following the increase in the prices of raw materials. Israel's high level of technological capability is a factor that is unique to it.

[22] The group of emerging economies includes 31 nations (according to the definition of the IIF). Israel is not included in this group.

[23] The UN's index for measuring how countries have dealt with the global competition for direct foreign investment. The index ranks countries according to the amount of direct investment absorbed. It measures the ratio between the country's share in direct international investment flows and its share in global GDP. See Box I.c.1 in the Survey of Activity in Foreign Currency in the Bank of Israel Annual Report for 2004.

of investment last year ($5.8 billion). The substantial decline in issues abroad was partly offset by the large increase in investment in shares on the secondary market, particularly on the Tel Aviv Stock Exchange.

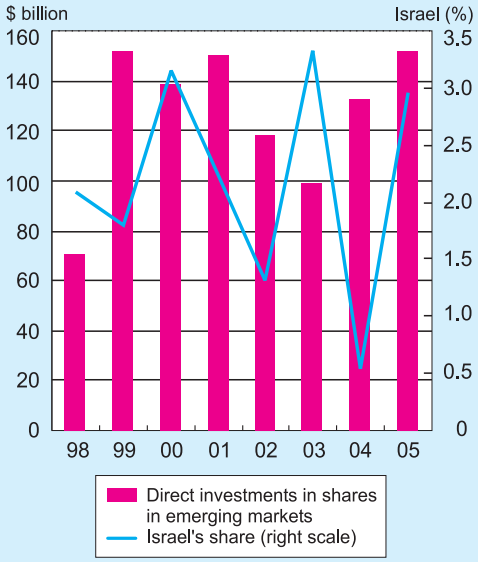
The net issue of shares of Israeli companies abroad declined significantly from $2.8 billion in 2004 to $1.3 billion[24] this year. About 20 Israeli companies issued shares for the first time this year and raised some $1.0 billion, most of it during the second half of the year. The drop in issues is consistent with the drop in initial public offerings in the US, particularly by small companies in the high-tech sectors (Figure 7.13). This is viewed as a leading indicator of the issues of Israeli companies abroad.

About 20 Israeli companies issued shares for the first time this year and raised some $1.0 billion, most of it during the second half of the year.

In addition, the possibilities of raising capital in Israel have improved this year as a result of the conditions in the local market and in fact a number of hi-tech companies did issue shares in Tel Aviv.

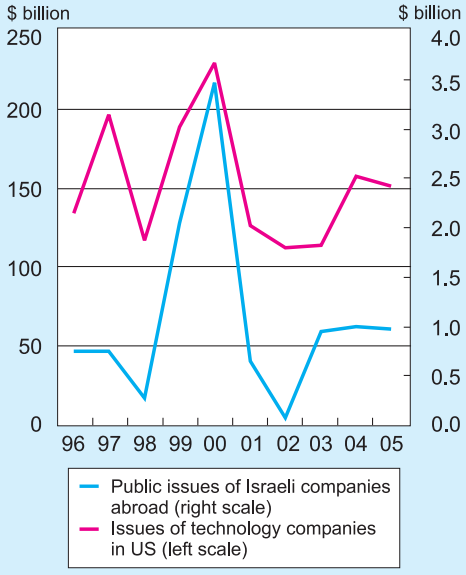
The investment in shares within the tradable portfolio of the Tel Aviv Stock Exchange grew by a record amount this year from $0.5 billion in 2004 to $2.1 billion in 2005 (Figure 7.10).

Figure 7.12
Direct Investments in Emerging Markets and Israel's Share of such, 1998–2005



SOURCE: Capital Flows to Emerging Market Economies, Institute of International Finance, September 2005.

Figure 7.13
Technology Share Issues in US and of Israeli Shares Abroad, 1996–2005 (Excl. issues of pharmaceutical companies)



SOURCE: Direct reports of issuing companies to Bank of Israel and Bloomberg.

[24] This amount does not include the issues of semi-Israeli companies. These are companies which are viewed as Israeli companies or are connected to Israel even though according to the balance of payments definition, they are considered foreign companies. These issues totaled some $1.4 billion this year which was about half of what they were the previous year.

There were a number of local and global factors behind the growth in investment: the capital flows to emerging economies, changes in short and long-term yields, the lack of investment alternatives in the developed economies and the continuing "search for yield". The local conditions include: real economic improvements—growth, a reduction in government debt and financing and an increase in exports; the improvement in the geopolitical situation with the conclusion of the Disengagement; the improvement in corporate profits due to higher sales and lower interest costs; and the accelerated program of privatization which included the privatization of a large bank.

Most of the investment in the Tel Aviv Stock Exchange was carried out in the first half of the year which was a continuation of the trend in late 2004. In contrast, changes in global yields and local geopolitical factors led to somewhat of a slowdown in investment. The activity of nonresidents on the Stock Exchange focused on the shares of large companies though it was heterogeneous. Thus, the investment was always diversified and no single direction can be identified.

Most of the investment in the Tel Aviv Stock Exchange was carried out in the first half of the year which was a continuation of the trend in late 2004. In contrast, changes in global yields and local geopolitical factors led to somewhat of a slowdown in investment.

Other investments by nonresidents, including shekel and foreign currency deposits with banks in Israel and the extension of direct credit and commercial credit, were balanced in 2005 in comparison to the net investment of about $0.2 billion the previous year. It is worth mentioning that since the end of 2004 there have been indications that the trend in withdrawals from nonresident deposits is reversing following three years in which withdrawals totaled some $0.7 billion per year. The factors behind the slowing of withdrawals include the improvement in the geopolitical situation and the decline in Israel's risk premium, the increase in yields on deposits as a result of the increase in short-term interest rates abroad and perhaps also the imposition of a tax on alternative deposits in Switzerland and Luxembourg.

c. Foreign investment by residents

Foreign investment by residents—including shares, bonds, real estate, credit, deposits and the foreign exchange reserves of the Bank of Israel—grew significantly this year from $11.5 billion to about $16.9 billion, primarily as a result of the increase in investment by the banking sector and institutional investors in foreign bonds (Figure 7.14).

This development is the result of progress made in lifting the restrictions on investing abroad for institutional investors, redemption of credit in foreign currency and increases in deposits by the business sector following the narrowing of the spread between interest rates in Israel and those abroad, and the reduction in the amount of financing required by the government. On the other hand, it appears that stability in long-term yields, despite the rise in short-term yields, moderated the export of capital by institutional investors who were concerned about capital losses when long-term yields do increase. The deposit of funds abroad by the banks, which is part of their liquidity management activity, continued at a high level. The increase in short-term yields beyond the increase in short-term interest rates also led to a rise in the private sector's investments in bonds (Figure 7.15).

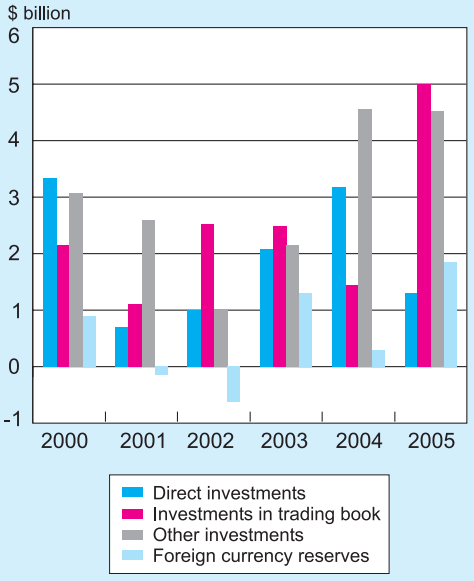
It appears that stability in long-term yields, despite the rise in short-term yields, moderated the export of capital by institutional investors who were concerned about capital losses when long-term yields do increase.

Institutional investors and the banks increased their investments in the tradable securities portfolio relative to the previous year while the investment of the household sector—which consists of individuals acting directly or indirectly through the mutual funds—declined.

Direct investment abroad has grown in recent years as a result of the globalization process which induces Israeli companies to expand their activities to markets abroad in order to maintain their competitiveness and grow.

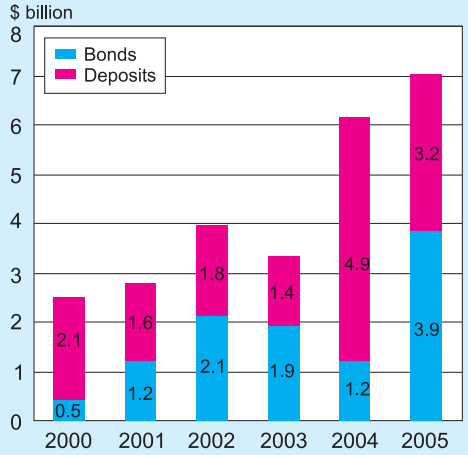
Direct foreign investment by residents totaled $2.3 billion this year as compared to $3.4 billion last year. Direct investment abroad has grown in recent years as a result of the globalization process which induces Israeli companies to expand their activities to markets abroad[25] in order to maintain their competitiveness and grow. An examination of the average direct investment (relative to GDP) in 1999–2004 of countries similar to Israel[26] for the last five years shows that the Israeli economy invests abroad less than other developed economies (1.7 percent of GDP as opposed to 2.7 percent) and more than developing economies which invest only 0.5 percent of their GDP. The rate of foreign investment is expected to eventually reach the level of developed countries. This year, the dominance of hi-tech sectors, which have a high proportion of multinational companies, in foreign investment was reduced.

Figure 7.14
Residents' Investments Abroad by Investment Category, 2000–2005



SOURCE: Central Bureau of Statistics.

Figure 7.15
Investment Flows of Private Sector in Bonds and Deposits Abroad, 2000–2005



SOURCE: Bank reports.

[25] The expansion of firms abroad is usually gradual. In the first stage, the firm purchases or builds a marketing network abroad in order to expand its number of potential customers. Later it expands its productive capacity abroad in order to exploit its advantage in production and development or to reduce distances and the cost of transport to the new markets.

[26] Countries which are similar to Israel in their technological level and per capital GDP. These include Ireland, Portugal, Spain, Italy, France, New Zealand, Hungary, the Czech Republic, Slovenia and Poland. These countries are ranked within 6 rankings above or below Israel in the ranking of technological achievement by the World Economic Outlook 2002. Their per capita GDP is on average some $2,600 higher than that of Israel.

Portfolio investment abroad grew significantly this year (by some $5.7 billion) to a total of some $7.8 billion. Most of the increase this year was recorded in investment in bonds ($3.7 billion). The banks invested some $1.6 billion in bonds abroad, using the surplus funds that they had accumulated as a result of the redemption of bank credit in foreign currency[27] by the business sector and an increase in its deposits.

The banks invested some $1.6 billion in bonds abroad, using the surplus funds that they had accumulated as a result of the redemption of bank credit in foreign currency by the business sector and an increase in its deposits.

Institutional investors,[28] which include the provident funds, the pension funds and the insurance companies, significantly increased their investments in foreign bonds and shares to some $3 billion. The increase was concentrated in the investment in bonds ($1.4 billion) relative to the negligible investment in bonds in 2004. Most of the investment ($1.1 billion) was made by the provident funds. The main factors behind the increase in foreign investment by institutional investors were the continuing process of diversification of their assets (following the equalization of tax rates on investment in foreign securities to those on local securities at the beginning of the year) and the reduced possibilities of raising funds in Israel following the reduction in the government's need for financing. A number of factors led to a slowing of the process of diversification abroad, including the time required for learning and for the creation of the infrastructure needed for these investments[29] and the boom in the local capital markets this year.

A number of factors led to a slowing of the process of diversification abroad, including the time required for learning and for the creation of the infrastructure needed for these investments and the boom in the local capital markets this year.

The investment in shares abroad totaled some $2.6 billion this year as compared to some $0.5 billion in 2004. Most of the investment (some $1.2 billion) was carried out by institutional investors. Most of the investment occurred during the second half of the year following assessments that shares in the local market were now correctly priced and that there was greater potential for profits on foreign exchanges. Households invested $0.7 billion abroad, primarily through mutual funds and mostly during the third quarter.

Other investments totaled some $4.9 billion slightly below those in 2004, although the composition of investment had changed. Government deposits and credit to customers went down, and their decline was offset by a rise in credit to nonresidents.

d. The current account, the financial account, the international investment position (IIP) and the external debt

The surplus in the current account is directed abroad and is manifested in the financial account as the export of capital and of debt (when there are no statistical differences). When the economy exports debt instruments, it increases its debt assets abroad. From the 1990s until 2002, the deficit in the current account was financed by transfers and the large-scale investment by nonresidents in equity instruments in the economy which does not increase the external debt. In 2005, the Israeli economy increased its debt assets significantly due to the surplus in the current account and the continuing capital

In 2005, the Israeli economy increased its debt assets significantly due to the surplus in the current account and the continuing capital investment in the economy by nonresidents.

[27] See the section on the shekel-foreign currency market in Chapter 4.

[28] See the section on the shekel-foreign currency market in Chapter 4.

[29] These are some of the factors that contribute to a "home bias", the tendency of local parties to invest less than the optimum in foreign assets.

investment in the economy by nonresidents. Box 7.1 describes the characteristics of the investment of nonresidents in the economy and that of residents abroad while distinguishing between debt and equity instruments.

Main developments in Israel's IIP in 2005

This year was characterized by the rapid growth of both assets abroad and foreign liabilities (Table 7.7). The growth in the economy's assets abroad was primarily the result of investment in the portfolio of tradable securities which reflected the portfolio adjustments carried out by all sectors of the economy. In the business sector, this adjustment was primarily carried out through the redemption of credit in foreign currency within the banking system which followed the reduction in interest rate differentials and which led to an increase of the banking system's deposits abroad. In the institutional and household sectors the portfolio adjustments were expressed as an increase in the investment in foreign securities following the equalization of tax rates. The increase in the economy's foreign liabilities was the result of the significant investment made by nonresidents—directly and through the tradable securities portfolio—during the first and fourth quarters and the rise in the prices of assets in the portfolio during the second half of the year.

The net external debt, which has been negative since 2002 (during which time the economy was a net lender abroad), continued to decline in 2005 and totaled a record \$23.2 billion.

The net external debt, which has been negative since 2002 (i.e., the economy was a net lender abroad), continued to decline in 2005 and totaled a record of minus \$23.2 billion. Israel also has a large surplus of short-term assets (debt instruments) since the government's debt is mostly long run while the foreign exchange reserves of the Bank of Israel and the foreign assets (debt instruments) of the private sector are primarily short term. It should be mentioned that net short-term debt is a central component in the assessment of the economy's overall risk and that the surplus of short-term assets contributes to the improvement in the country's credit rating. The balance of the public sector's external debt was some \$31 billion in 2005. The government is the

Table 7.7
Israel's International Investment Position, 2001–05

(end-of-year balance, NIS billion)

	2001	2002	2003	2004	2005
Total assets	72.8	78.8	89.9	103.6	118.4
Of which Debt instruments	65.5	71.0	78.3	87.8	98.7
Direct external investment	9.2	10.3	13.1	16.7	18.7
Portfolio investment	8.0	10.1	13.6	16.5	24.9
Other external investments	32.2	34.2	36.8	43.1	46.6
External assets of general government	23.4	24.2	26.4	27.2	28.2
Total liabilities	108.7	105.3	123.6	136.5	153.0
Thereof: debt instruments	66.8	69.1	72.1	75.8	75.6
Direct investment	23.0	23.2	29.4	31.8	36.8
Portfolio investments	39.1	33.7	44.8	54.0	66.7
Other investments	46.6	48.4	49.4	50.7	49.5
Net liabilities	35.9	26.5	33.7	32.9	34.6
Of which: Net debt instruments	1.2	–2.0	–6.2	–12.0	–23.2

SOURCE: Based on reports from banks, corporations, government offices, and the Securities Authority.

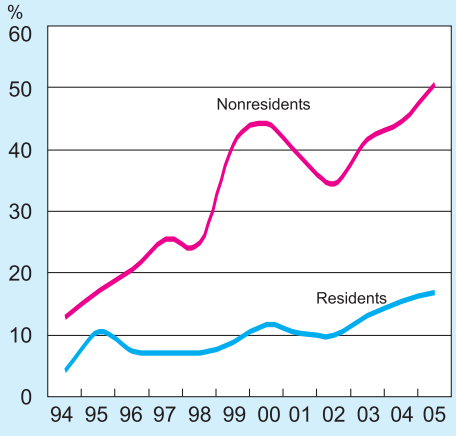
main borrower in the public sector and its debt accounts for some 42 percent of the economy's total. During 2005, the government's redemption of debt exceeded its issue of new debt. The budget restraint and the exploitation of privatization revenues reduced the need for issuing external debt.

Box 7.1
The changes in the structure of foreign assets and liabilities during the last decade

Since 1994, nonresidents have invested heavily in Israeli shares and the share of equity assets in their total assets in Israel has increased consistently. This is in contrast to the moderate increase in the share of equity assets in the total foreign investments of residents. Thus, at the end of 2005, the investment of residents in shares—directly and in the portfolio of tradable securities—was only 17 percent of their total foreign assets while the investment in Israeli shares constituted about one half of the asset portfolio of nonresidents (Figure 1).

The increase in investment by nonresidents in equity assets during the last decade paralleled that in other emerging economies. This is s reflection of a number of factors: the integration of global financial markets, the growth of multinational corporations, the elimination of tax discrimination and the liberalization in foreign currency regulations and finally the improvement in regulatory and technological infrastructures in developing countries. The motive for direct investment in emerging economies is often to take advantage of lower wages in the traditional industries and to thus lower production costs. A phenomenon which is unique to Israel is the direct investment by foreign investors in Israeli equity assets which is directed primarily to the relatively high-risk hi-tech sectors. The motives in this case is the expectation of a high return as a result of the rapid increase in the value of the company and the subsequent realization of the investment or the rapid growth in profitability following a technological innovation that will allow the

Figure 1
Share of Capital Assets in Total Asset Portfolios of Nonresidents in Israel and Residents Abroad, 1994–2005



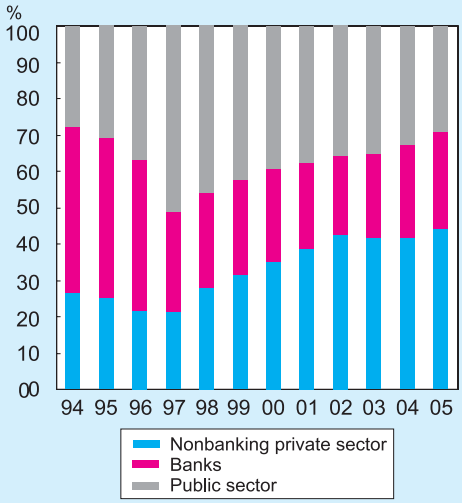
SOURCE: Based on bank and company reports.

payment of a dividend. With regard to the tradability of the assets, some 45 percent of the portfolio of residents is in tradable assets. This is similar to the situation among nonresidents except that the value of the tradable portfolio of nonresidents fluctuates much more as a result of the proportion of shares within it. Thus, nonresidents hold an investment portfolio in Israel which has a higher level of risk and return than is characteristic of the foreign investment portfolio of residents.

There were also far-reaching transformations in the structure of financial markets in Israel which were primarily the result of the liberalization in foreign currency regulations and the elimination of the discriminatory taxation on foreign investments. To this can be added the surplus in the current account of the balance of payments since 2003. These developments led to rapid growth in the economy's assets abroad and during the last five years Israel has had a surplus in debt instruments, i.e. it has been a net lender abroad.

During the last dozen years, there has been a continuous increase in the foreign exchange reserves of the Bank of Israel but the main factor behind the transformation of the economy into a net lender and the increase in assets abroad (debt instruments) was the non-banking private sector and in particular the business sector. This was reflected in the growth in its deposits abroad (which contain export revenues and funds raised through the issue of shares and the raising of capital) and the increase of its holdings of foreign bonds. Since 1994, the non-banking private sector has increased its assets abroad six-fold while the assets of the banking system and those of the public sector (primarily the foreign exchange reserves of the Bank of Israel) grew two-fold and four-fold, respectively. During the years 1994-96, the banking system was the dominant sector in the economy's investment abroad. Thus, the assets of the banks constituted close to 50 percent of the economy's total assets abroad (debt instruments). During the period 1997-2001, the reserves of the Bank of Israel accounted for the lion's share and since 2002 the non-banking private sector has had the largest share (Figure 2).

Figure 2
Various Sectors' Share of Assets (Debt Instruments) Abroad, 1994–2005



SOURCE: Based on bank and company reports.