

Chapter 6

The Balance of Payments

The current account deficit rose by some \$1.4 billion in 1993, after being more or less in balance since 1990. The deterioration reflects a decline in unilateral transfers to the public sector, a fall in interest income, and a rise in the civilian import surplus (excluding capital). Alongside the increase in the latter, both imports and exports continued to soar while products and markets diversified. All this points to Israel's growing openness to world markets, as does the surge in investment in fixed assets abroad.

During 1993 the trend of capital movements by the nonfinancial private sector changed. In the first few months the substantial export of capital which had begun at the end of 1992 persisted, but subsequently there was an inflow of capital. In the second half of 1993 the expected high yield on the domestic stock market appears to have been the dominant feature in determining the financial investments of the public in general, and capital movements in particular.

1. MAIN DEVELOPMENTS

The current account deficit rose to \$1.4 billion, after being more or less in balance since 1990, when mass immigration began (Table 6.1). The deterioration in the deficit was mainly due to the reduction of the public sector balance-of-payments surplus, while the current account deficit of the private sector deviated only slightly from its average level in 1991–92, when it rose in the context of the process of immigrant absorption. The considerable reduction of the public sector's current account surplus in 1993 was the result of a decline in both unilateral transfers and interest income.

The civilian import surplus (excluding capital) rose by some \$0.6 million from 1992, a two percentage point increase in its share of GDP (at constant prices). The rise in the import surplus/GDP ratio in 1993 reflects a relatively small demand surplus arising from the fact that demand outstripped supply. This was because, in the context of supply-side difficulties, supply could not adapt quickly to the sharp change in the composition of demand (see Chapter 2).

The relatively limited extent of excess demand was evinced by the lack of a significant change in the real exchange rate (annual average), i.e., in the ratio of prices of tradable to nontradables. The absence of real appreciation is particularly noteworthy in view of this year's excess demand for (nontradable) housing, which pushed housing prices up considerably.

Table 6.1
Selected Balance-of-Payments Indicators, 1980-93

	1980-84	1985-88	1989	1990	1991	1992	1993
<i>Billions of current \$</i>							
Total current account	-1.4	0.5	1.2	0.6	-0.4	0.2	-1.4
Adjusted current account ^a	-1.4	0.7	1.1	0.4	-0.6	0.3	-1.1
Import surplus							
Total	4.3	4.7	3.9	5.3	7.1	6.7	8.1
Civilian ^b	2.7	2.8	2.7	3.8	5.1	5.2	6.0
Civilian, excl. capital services	1.7	1.1	1.3	2.6	4.2	4.1	4.6
Net unilateral transfers							
To public sector	1.9	3.7	3.1	3.8	4.4	4.0	3.7
To private sector	1.1	1.3	2.0	2.1	2.3	2.9	3.0
Implied private capital imports ^c			0.6	0.4	-0.1	-2.4	1.1
External debt							
Net	14.9	17.9	15.7	15.1	15.2	15.2	15.7
Gross	26.2	30.7	31.3	32.8	33.3	34.1	36.0
Foreign reserves	3.7	4.8	5.6	6.5	6.4	5.3	6.7
<i>Annual change, percent (volume)</i>							
Exports ^d	4.8	2.6	4.0	5.0	1.3	14.4	12.7
Civilian imports ^d	7.5	4.0	2.0	10.2	15.3	11.9	11.4
World trade	2.3	5.7	7.1	5.2	3.5	4.7	2.4
Exchange rate							
Against the dollar	0.08	1.47	1.92	2.02	2.28	2.46	2.83
Against the 5-currency basket	0.07	1.48	2.00	2.21	2.48	2.73	3.06
Net external debt as percent of							
GNP	62.3	57.6	36.0	28.6	26.2	23.9	24.5
Exports	145.5	140.5	93.5	82.5	81.8	73.3	70.9
Relative prices (1988 = 100)							
Imports/domestic resource use ^e	126	112	100	98	91	88	88
Exports/domestic resource use ^e	128	109	102	98	96	93	95
Terms of trade ^d	100	98	95	93	100	97	94

^a Adjusted for advances on defense imports.

^b Excluding direct defense imports.

^c Defined as the difference between the private sector's purchase of foreign exchange and its current account.

^d Excluding diamonds and capital services.

^e Implicit price index of imports (exports) *divided by* implicit price index of domestic use of resources (from the national accounts). Excludes direct defense imports.

SOURCE: Based on Central Bureau of Statistics data.

Table 6.2
Goods and Services Account, 1990-93^a

	\$ million				Annual change, percent					
					Price			Quantity		
	1990	1991	1992	1993	1991	1992	1993	1991	1992	1993
Imports										
Goods excl. fuel and diamonds	10,125	12,054	13,345	14,569	-3.3	-1.1	-3.6	23.2	11.9	13.2
Fuel	1,535	1,474	1,713	1,742	-23.3	-4.8	-11.3	25.2	22.1	14.6
Diamonds	2,895	2,551	2,911	3,341	-0.5	5.6	0.7	-11.4	8.1	14.0
Services ^{b,c}	4,456	4,767	5,002	6,061	8.0	-1.2	3.3	-0.9	6.2	17.3
From the administered areas	965	901	1,171	749	0.8	3.9	5.7	-7.4	25.2	-39.5
Subtotal	19,977	21,747	24,143	26,462	-2.3	-0.4	-1.9	11.5	11.5	11.7
Capital services	2,739	2,558	2,525	2,396						
Direct defense imports	1,501	1,973	1,466	2,125						
Total imports	24,217	26,277	28,134	30,983						
Exports										
Goods, excl. diamonds ^b	8,370	8,357	9,158	10,434	-0.9	0.4	-3.6	0.8	9.2	18.2
Diamonds ^d	3,054	2,690	3,049	3,356	3.0	-0.3	9.8	-14.5	13.7	0.2
Services ^{b,c}	4,977	5,241	6,419	6,788	6.7	-0.5	-3.4	-1.3	23.0	9.4
To the administered areas	971	1,238	1,429	1,243	3.4	2.5	-5.8	23.3	12.6	-7.7
Subtotal	17,372	17,526	20,055	21,820	2.4	0.2	-1.8	-1.5	14.2	10.8
Capital services	1,496	1,661	1,410	1,042						
Total exports	18,868	19,187	21,465	22,863						

Trade deficit ^b				
Excl. diamonds and fuel imports	1,755	3,697	4,188	4,135
Current surplus, diamonds	159	138	139	14
Total trade deficit	3,132	5,033	5,762	5,862
Surplus on services account ^{b,c}	521	474	1,416	726
Civilian import surplus ^c	2,605	4,221	4,088	4,641
Capital services imports, net	1,243	896	1,115	1,354
Civilian import surplus	3,848	5,118	5,203	5,995
Total import surplus	5,349	7,090	6,669	8,120

^a Imports c.i.f., exports f.o.b.

^b Excluding the administered areas.

^c Excluding capital.

^d See table 6.5 for breakdown of diamond exports.

SOURCE: Based on Central Bureau of Statistics data.

Together with the rise in the import surplus, both imports and exports expanded appreciably, a development which is consonant with Israel's increasing openness to world markets. The latter was reinforced by the liberalization of trade and the improvement of Israel's geopolitical situation. The greater openness of recent years is reflected by the expansion of trade as well as by the accelerated process of diversification of both goods and markets.

The third stage of trade liberalization came into effect in September 1993. Tariffs on imports from third countries (countries with which Israel does not have trade agreements) were reduced, but at the same time there was some backsliding in tariff reduction on textiles. A similar departure from the overall trend was evident in 1993 regarding the regulations accompanying the Mandatory Tenders Law which gives preference to domestic products. These deviations from the original intention may undermine the credibility of the government's policy and impair the efficient allocation of resources.

The volume of exports continued to rise rapidly—by about 11 percent—in 1993, after growing by 14 percent in 1992 (Table 6.2). The increase was especially notable in industrial exports (excluding diamonds), which rose by a real 19 percent. Service exports also rose substantially due to the continuing increase in tourism. At the same time, imports grew by 12 percent, with a rise in the share of producer durables and intermediates. Exports to nontraditional markets have led export growth since 1992, and the share of these markets in imports has also risen. The rapidity with which export rose in 1993 is not necessarily an indication of future trends, and its implications for further economic growth are not clear because of the special and nonrecurring nature of some of the export transactions, especially in defense. This is reflected by wider monthly fluctuations in industrial exports in 1993 than in 1988–92.

The greater openness of the economy is also indicated by firms' fixed investment abroad. Israeli firms purchase active companies in order to gain a foothold in international markets, and the share of these in total capital movements is increasing. Despite the improvement in Israel's international financial standing, however, no substantial increase in direct investment in Israel by nonresidents is yet discernible, their interest being indicated mainly by the purchase of shares issued abroad by Israeli companies.

During 1993 the trend of capital movements of the nonfinancial private sector reversed. Starting in the second quarter, the public purchased foreign currency from the Bank of Israel to an amount that fell short of current account deficit financing needs by \$0.6 billion, after excess purchases of \$1.3 billion at the end of 1992 and in the first quarter of 1993. This shift was reflected primarily in residents' financial investment abroad. In 1993 net sales by the public amounted to almost \$100 million, after it had invested approximately \$1 billion abroad in 1992. The capital inflow, which began at the end of February 1993, persisted even after the monetary expansion of the second half of the year. This trend is unusual, because in Israel monetary expansion usually causes a capital outflow. The dominant feature in determining the public's financial investment

pattern in the second half of 1993 appears to have been the relatively high yield on Israel's stock market.

The Bank of Israel's foreign reserves rose by \$ 1.3 billion, after declining by a similar amount in 1992. In the last few years the composition of the sources of the reserves has changed, because of the gradual reduction of the reserve requirement on restitutions deposits. This caused a decline in the commercial banks' compulsory deposits with the Bank of Israel and an increase in their deposits in excess of the reserve requirement, which are relatively short term.

At a time of immigrant absorption capital imports smooth and speed up the transition to a higher level of output, which cannot be attained through domestic resources alone. During immigration the ability to borrow abroad on favorable terms assumes greater importance, as does the need to utilize loans effectively to foster sustainable growth.

Net capital imports by the government rose steeply in 1991–92, when a total of some \$ 1.4 billion was borrowed abroad. This increase indicates that the government responded to the rise in the private sector deficit in the first few years of immigration, and that special grants received then obviated to some extent the need for greater net borrowing. Nonetheless, the continued reduction of the net external debt/GNP ratio, as well as its significantly lower level in the early 1990s than in the years before the influx of immigrants, indicates that in immigrant absorption relatively little use was made of available external sources. Greater utilization of Israel's potential credit lines could help to smooth consumption fluctuations in the short term, but in the long run this is justified and desirable only for financing productive investment whose yield is at least equal to the cost of capital.

The slight increase in the external debt/GNP ratio from 1992 to 1993 reflects the growth of the current account deficit. The first tranche (\$ 2 billion) borrowed under the US government guarantees was used for much of the deficit financing. The possibility of borrowing \$ 10 billion under these guarantees creates a favorable and stable financing framework for Israel in the coming years—even beyond the amount specified—by improving Israel's country risk rating and hence the interest rate. Israel's risk rating has been steadily improving in the last few years, the significant advance of 1992 persisting in 1993 (and at the beginning of 1994). This trend reflects both the economic and the geopolitical situation, although Israel's long-standing economic recovery appears to be only partly reflected in the rating.

2. THE CURRENT ACCOUNT

The current account showed a deficit of \$ 1.4 billion in 1993, following a surplus of \$ 200 million in 1992.¹ This increased the external debt and raised the debt/GNP ratio by

¹ When adjusted for advance payments on defense imports, the current account showed a deficit of

Table 6.3
Net Balance of Payments, 1989-93^a

	(\$ million) ^b				
	1989	1990	1991	1992	1993
Goods and services account	-3,864	-5,348	-7,091	-6,667	-8,120
Private sector	-1,710	-3,013	-4,460	-4,360	-4,829
Public sector ^c	-2,154	-2,335	-2,631	-2,307	-3,291
Unilateral transfers	5,101	5,906	6,674	6,885	6,747
Private sector	2,041	2,119	2,319	2,853	3,034
Public sector	3,060	3,787	4,355	4,032	3,713
Current account	1,237	558	-417	218	-1,373
Private sector	331	-894	-2,141	-1,507	-1,795
Public sector	906	1,452	1,724	1,725	422
Medium- and long-term capital movements	150	150	129	-135	1,834
Private sector	78	218	-526	-841	-84
Public sector	71	-68	654	706	1,918
Basic account	1,387	708	-288	83	461
Private sector	409	-676	-2,667	-2,348	-1,879
Public sector	977	1,384	2,378	2,431	2,340
Short-term capital movements	-546	-238	152	-345	-420
Nonfinancial private sector	-253	-22	337	-408	-678
Public sector	-292	-215	-185	64	258
Capital movements via banking system	-667	-227	-370	-1,305	587
Errors and omissions	1,227	272	332	445	853
Effect on foreign reserves ^d	-1,398	-515	173	1,457	-1,481

^a Figures may not add due to rounding.

^b At current prices.

^c The deficit on the public sector goods and services account is defined as direct defense imports *plus* other government imports *plus* net interest payments abroad *less* other income.

^d Increase (-)/decrease (+); adjusted for dollar exchange rate of currencies in basket.

SOURCE: Based on Central Bureau of Statistics data.

0.7 percentage points.² The higher level of the current account deficit in 1993 than in 1992 largely reflects the reduction of the surplus on the public sector current account by some \$ 1.3 billion, and an increase of \$ 300 million on the private sector current account deficit (Table 6.3). Two main factors were responsible for the decline in the public sector surplus. First, unilateral transfers to the public sector were lower than in 1992. Half the US civilian aid for 1991 was delayed to the following year, so that unilateral transfers showed an additional \$ 600 million in 1992. Second, net dollar interest expenses rose by \$ 250 million (Table 6.11), as a result of both the decline in the average level of the

\$ 1.1 billion, compared with a surplus of \$ 300 million in 1992.

² The difference between the deficit on current account and the increase in the debt derives from error: and omissions, revaluations, and net investments abroad.

reserves, following the liberalization of foreign-exchange control at the end of 1992, and the worldwide fall in interest rates, the principal consequence of which was the reduction of interest income.

The civilian import surplus (excluding capital) rose by some \$600 million in 1993, with no similar increase in the level of total investment. There was, however, a sharp and significant change in the composition of investment. Residential investment dropped by 26 percent while fixed investment in the business sector rose by 12 percent, and investment in roads soared by 60 percent. The creation of permanent employment is an important element in the absorption of mass immigration—which is expected to stimulate growth—and thus in the utilization of its growth potential. The change in the composition of investment increased capital stock to a level which enabled business-sector product to continue growing by an annual 6 percent, alongside a 3.5 percent increase in the civilian labor force. The increase in the external debt would seem to be justified, therefore, particularly since at present the yield on investments is higher than the marginal cost of net borrowing.

The share of the import surplus in GDP rose by two percentage points (at 1990 prices). This reflects the continued rapid growth of domestic demand—6.4 percent—while GDP rose by 3.5 percent, even though the rates of unemployment and investment in the business sector of the last few years indicate under-utilization of capacity. The increase in the share of the import surplus in GNP in 1993 appears to be due to both sharp changes in the composition of demand and supply rigidities (see Chapter 2).

As stated, the shifts in the composition of demand are particularly apparent in investment, where residential construction—which is relatively value-added-intensive—plummeted, and investment in equipment and inventory—which are relatively import-intensive—rose. This represents the net transition of demand from domestic output to complementary imports, while total demand remains constant.

Alongside the decline in construction output, there was uncertainty regarding activity in the construction industry in 1993. Both the extent of the decline in government demand for construction (a decline in residential and an increase in infrastructure investment) and the private sector's response to these changes were unclear. In addition, the closure of the administered areas affected supply. Industries ancillary to construction were adversely affected and were unable to meet the rise in demand in other industries. Uncertainty also prevailed with regard to exports. Most of the increase in exports was directed towards nontraditional markets, and firms expanded their exports by importing intermediates rather than producing them in Israel. This appears to be the outcome of Israeli producers' and exporters' lack of experience as regards ties with these new markets. Thus, in 1993 the import of inputs involved a slower increase in output, as is indicated by the faster rise of imported intermediates than of primary inputs. Imported intermediates contributed some 28 percent to the increase in inputs (excluding diamonds and fuel) in 1990, 39 percent in 1992, and 60 percent in 1993. Changes in production processes, as can be inferred from the change in the composition of imported intermediates, support the decline in direct and indirect value added in domestic production.

Table 6.4**Contribution to Change in Imports and Exports,^a by Main Trade Areas, 1990-93**

	(percent)			
	1990	1991	1992	1993
Sources of imports				
EU	41.8	38.9	62.6	28.6
EFTA	9.0	7.7	3.0	12.5
Rest of Europe	3.6	5.8	-1.8	6.8
US	19.2	29.3	-0.7	30.5
Rest of America	2.2	3.0	-2.2	0.3
Japan	9.2	9.5	17.4	3.8
Rest of Asia	4.3	6.5	7.6	14.7
Other	10.7	-0.7	14.0	2.8
Total	100.0	100.0	100.0	100.0
Nontraditional markets ^b	39.0	31.8	38.1	40.9
<i>of which</i> Excluding EFTA	30.0	24.1	35.1	28.4
Excluding EFTA and Japan	20.8	14.6	17.6	24.5
Destination of exports				
EU	92.8	67.0	13.9	2.8
EFTA	1.9	-40.4	-2.1	3.3
Rest of Europe	7.0	58.0	11.3	19.3
US	33.5	133.5	31.7	26.2
Rest of America	10.9	-37.9	2.7	6.4
Japan	2.2	0.3	-1.0	2.0
Rest of Asia	4.4	-24.5	22.9	17.4
Other	-48.8	-73.6	18.3	21.4
Total	100.0	100.0	100.0	100.0
Nontraditional markets	-22.4	-117.9	52.2	70.0
<i>of which</i> Excluding EFTA	-24.3	-77.5	54.3	66.6
Excluding EFTA and Japan	-26.5	-77.9	55.3	64.6

^a Not including diamonds and defense imports.

^b The traditional markets are the EU and the US.

SOURCE: Based on Central Bureau of Statistics data.

Furthermore, some of the export demand appears to have been met from inventory, and hence did not contribute to output in 1993. This is explained in part by the timing of export, which is not usually synchronous with production, and in part by sales from long-term inventory.³ Furthermore, ties with new trading areas and the liberalization of trade made it easier to divert demand to imports.

³ For example, exports of transport equipment rose by \$330 million, even though production fell by 7 percent and labor input by 8 percent. In addition, most of the increase in chemicals exports in 1993 was in the product of refineries, which has very low value added.

Alongside the rise in the share of the import surplus in GNP, in 1993 average prices of imports and exports were relatively stable vis-à-vis those of output (these ratios serve as an indication of the real exchange rate). The slight real appreciation during the year apparently reflected negligible excess demand which was not sufficient to affect the annual average. The stability of relative prices indicates that the transfer of demand to imports was due to the composition of demand and supply rigidities rather than to the substitution effect.

International economic and political developments contributed to the increase in Israel's level of trade through the establishment of ties with new markets. Several measures were introduced to reduce government involvement in foreign trade. First, under the trade agreement with EFTA which went into effect in January, the regulations governing trade with the EU were also applied to these countries. Second, as part of the process of increasing exposure to imports from third countries, the second stage of tariff reduction went into effect in September. Third, the import levy and the exchange-rate insurance premium for exporters were abolished in July.⁴ Fourth, the tax on foreign travel and the surcharge on imported services were canceled at the beginning of the year. This marked further progress towards exchange-rate unification. Multiple exchange rates serve as an administrative tool enabling discriminatory government intervention that artificially reduces the volume of trade but not necessarily the import surplus. The harm thus done to the volume of trade gives rise to misallocation of resources and reduces social welfare.

The decision to slow the pace at which the textiles, clothing and glass industries are exposed to competing imports, and the provisions of the Mandatory Tenders Law which give preference to domestic products, represent a retreat from the liberalization program. This may impair the credibility of the government's policy and undermine economic stability and competitiveness.

Exports (excluding diamonds and the administered areas)

The rate at which exports rose in 1993 was even faster than in 1992—18.2 and 9.2 percent respectively—reaching a level of \$ 10.4 billion (Table 6.5). Industrial exports, which rose by some 19 percent, led this growth. The ability of industrial exports to adjust to new conditions, displaying flexibility in utilizing opportunities, is notable. Some of the increase in goods exports in 1993 is the result of nonrecurring transactions from inventory, so that its persistence is uncertain. Beside the impressive volume growth, however, Israel's exports are undergoing diversification as regards both

⁴ These were the last steps towards exchange-rate unification in accordance with the requirements of the International Monetary Fund (IMF), and enabled the sheqel to become a convertible currency in the current account. According to Article 8 of the Articles of Agreement, regarding commitment to convertibility in the current account, a member state of the IMF may neither limit payments abroad on current account transactions nor operate multiple exchange rates (tariffs are not affected).

Table 6.5
Merchandise Exports (f.o.b.), 1990-93

	\$ million				Annual change, percent					
					Price			Quantity		
	1990	1991	1992	1993	1991	1992	1993	1991	1992	1993
Agricultural exports	656	643	552	547	-1.2	-12.7	-4.4	-0.8	-1.7	3.8
Citrus	180	150	115	121	8.3	-11.5	18.0	-23.4	-13.0	-11.3
Other	476	493	436	427	-3.7	-13.0	-9.0	7.6	1.8	7.3
Industrial exports	7,916	7,915	8,921	10,235	-0.9	1.4	-3.4	0.8	11.4	18.8
Metals, machinery, electronics	3,492	3,504	4,064	5,042	-0.6	1.9	-1.5	0.9	13.8	26.0
Chemicals, rubber, plastics	1,818	1,834	1,996	2,372	-2.4	-1.7	-5.8	3.3	10.7	26.1
Other	2,606	2,616	2,862	2,821	0.8	3.5	-4.2	-0.5	5.7	2.9
Polished diamonds (net)	2,783	2,469	2,645	3,014	3.3	0.0	10.5	-14.1	7.1	3.1
Unpolished diamonds (net)	271	220	405	342	0.0	-1.9	4.2	-32.9	104.1	-24.7
less Returned exports	24	28	44	55						
Net exports ^a	11,603	11,219	12,479	14,083	-0.0	0.3	-0.9	-3.3	10.9	13.9
Balance-of-payments adjustments	-179	-172	-272	-293						
Exports to the administered areas	714	982	1,106	1,015	2.9	2.2	-6.2	33.6	10.2	-2.1
Total exports	12,139	12,029	13,313	14,805	0.2	0.4	-1.3	-1.1	10.2	12.6
Total excl. diamonds and exports to the administered areas	8,370	8,357	9,158	10,434	-0.9	0.4	-3.6	0.8	9.2	18.2

^a As per foreign trade data.

SOURCE: Based on Central Bureau of Statistics data.

products and markets. Political and economic developments indicate that this will intensify, bolstering Israel's economic strength.

During the course of 1993, monthly fluctuations in industrial exports exceeded the long-term growth trend (since 1988). Most of these fluctuations were evident only in metals, machinery, electronics, and transport equipment, which together account for 45 percent of industrial exports. Thus, the increase in this combined industry in 1993 was the result of several large transactions. An examination of trading regions indicates that a large part of the increase in fluctuations was in markets where most exports are connected with defense. This supports the view that much of the rise in industrial exports in 1993 was in defense-allied industries. These are areas in which Israel traditionally has a comparative advantage and international reputation. In the context of the decline in domestic demand for defense products, diverting production to exports is desirable, though data on lower output and employment in the defense industries raise doubts as to the continuation of these growth rates for defense exports.

When examined by trading region, exports did not increase uniformly, being affected to a great extent by international economic and political developments which influenced world demand for exports in general, and for Israeli exports in particular. First, world trade grew by a moderate 2.4 percent,⁵ because of the recession in the industrial countries, first and foremost Europe. This is reflected most clearly by the zero real GDP growth rate of the EU in 1993. This has a direct effect on total imports by the EU, which fell by 3 percent. Israel's exports to the EU rose by about 1 percent in 1993.⁶ According to this rate of increase, the market share of Israel's exports in this region rose in 1993, but by less than in the last few years, as well as falling below the growth rate of Israel's exports to other regions. The share of this market thus fell from 38 percent of exports in 1992 to 33 percent. Second, the US economy rallied during 1993, with real GDP rising by 3 percent and imports by 9 percent. Israeli industry utilized this recovery, increasing its exports there by some 16 percent. Third, the share of developing countries in international trade rose as a result of their rapid rate of growth and the recession in the industrial countries, as well as the fact that the markets of eastern Europe opened up to world trade. One indicator of this is the 9 percent increase in imports by these countries, and especially those in Asia, where the increase was 14 percent. Until recently Israel could not utilize the expanding market of the developing countries, for geopolitical reasons. Since 1992, however, it has benefited from their increasing openness. The volume of transactions with these countries grew in 1992, and continued to do so in 1993.

Thus, Israeli exports increased their share of each of these markets. Furthermore, in view of the worldwide decline in prices of manufactures (some 4.2 percent), which exceeded the fall in prices of Israeli manufactures (about 3.5 percent), there also appears to have been an exogenous rise in world demand for Israeli exports.

⁵ *World Economic Outlook*, IMF, April 1994; *Economic Outlook*, OECD, December 1993.

⁶ Quantitative rates of change and weights are affected by changes in cross rates. Studies have shown that these changes have not significantly affected the distribution and volume of trade with Israel since 1991.

Table 6.6
Merchandise Imports (c.i.f.), by Economic Destination, 1990-93

	\$ million				Annual change, percent					
					Price			Quantity		
	1990	1991	1992	1993	1991	1992	1993	1991	1992	1993
Consumer goods	1,585	1,876	2,320	2,532	-3.2	2.6	-1.0	22.3	20.5	10.2
<i>of which</i> Durables	769	957	1,250	1,283	-5.5	3.7	2.6	31.7	25.9	0.1
Capital goods	2,194	2,996	3,180	3,577	-0.2	2.5	-1.6	36.8	3.5	14.3
<i>of which</i>										
Machinery and equipment	1,625	2,107	2,240	2,522	1.3	2.4	-3.8	28.0	3.8	17.1
Land transport equipment	397	659	810	917						
Total intermediates	11,373	11,868	13,130	14,190	-6.7	-1.8	-4.7	11.8	12.7	13.4
Fuel	1,535	1,474	1,713	1,742	-23.3	-4.8	-11.3	25.2	22.1	14.6
Diamonds (net)	2,895	2,551	2,911	3,341	-0.5	5.6	0.7	-11.4	8.1	14.0
Other	6,942	7,842	8,505	9,107	-4.5	-3.2	-5.3	18.3	12.1	13.0
Merchandise n.e.s. ^a	-45	-50	-66	-55						
Total net imports	15,107	16,691	18,564	20,245	-5.3	-0.5	-3.6	16.6	11.7	13.2
Balance-of-payments adjustments	-551	-611	-595	-593						
From administered areas	181	190	249	178	-2.2	7.5	-6.2	7.3	21.9	-23.8
Total	14,737	16,270	18,218	19,830	-5.2	-0.4	-3.7	16.5	12.4	13.0
Total excl. fuel, diamonds, and imports from administered areas	10,125	12,054	13,345	14,569	-3.3	-1.1	-3.6	23.2	11.9	13.2

^a Net of returned imports.

SOURCE: Based on Central Bureau of Statistics data.

Exports to nontraditional markets continued to grow in 1993, and they accounted for 70 percent of the increase in exports, their share rising from 33 percent in 1992 to 39 percent in 1993. In addition, this increase was spread over many countries in both eastern Europe and East Asia. This reduces the uncertainty associated with penetrating new markets, especially in view of the political instability of some of them, and in eastern Europe in particular. In addition to the diversification of markets, there was also a far wider variety of products. The impressive 86 percent growth rate in exports to eastern Europe encompasses all industries.

The rise in industrial exports was most prominent in three major industries (out of 17)—electrical equipment and electronics, transport equipment, and chemicals, which together accounted for 50 percent of industrial exports in 1993. The increase in dollar exports by these three industries constituted some 96 percent of the \$ 1.3 billion rise in industrial exports. Most of the increase in chemicals exports (65 percent) was from the refineries, as a solution for surpluses, and it is not clear whether this will recur. These contributed some 3 percent to the rise in industrial exports.

Changes in target markets also affected the composition of exports. The recession in the EU apparently had an adverse effect on industries which export mainly to those countries—textiles and clothing (62 percent of these exports are to the EU),⁷ and wood, paper, and printing (55 percent). Israel's major industry—electrical equipment and electronics—which accounted for 22 percent of industrial exports in 1992, was not affected to such a great extent because only 22 percent of its exports go to Europe. In 1993 this industry's exports grew by 29 percent, following its average annual growth rate of 17 percent since 1990, and outstripping all other industries. This industry is representative of industry in general in its growth trend together with the diversification of its markets. The most impressive increase—350 percent—was in its exports to eastern Europe. Exports to Latin America rose by 57 percent, and to Asia (excluding Japan) by 170 percent. As a result, the share of these exports going to nontraditional markets rose from 33 percent in 1992 to 46 percent in 1993.

As stated, most of the increase in exports in the last few years has been in electrical equipment and electronics. Other export industries are burgeoning, however, as production becomes more competitive. An example is textiles and clothing, whose exports increased at a real annual rate of 10 percent in 1990–92, totaling \$ 1 billion. Although the rate of increase of textiles exports fell to about 5 percent in 1993, this was due to a shift from production for the domestic market to that for export (output in the industry remained unchanged in 1993). The industry's expansion was based on the penetration of new markets.

⁷ Annual average 1990–92.

Imports

Imports rose by 13 percent in 1993 (Table 6.6), the main contribution to the increase coming from intermediates and capital goods, which account for 67 percent of imports (excluding fuel and diamonds). The share of each of these items rose by more in 1993 than in 1992, while that of imported consumer goods fell. Imported intermediates (excluding fuel and diamonds) rose, while their prices (in dollar terms) fell by about 5 percent—a sharper fall than the 3.8 percent decline in world prices of raw materials (excluding heating oil). Part of the reduction in the relative price of imported intermediates is due to Israel's access to markets which were formerly closed to it, and part to the difference between the composition of Israel's raw materials and those of the rest of the world.

Imports of capital goods rose by 14 percent in 1993, and within this category imports of machinery and equipment increased by 17 percent. In 1992 both these categories rose by 4 percent. Thus, the contribution of this item to the expansion of imports went up from 4 to 18 percent, and this is consistent with the shift in the composition of investment in 1993.

Imports of consumer goods rose by 10 percent, after an annual increase of approximately 21 percent in 1991 and 1992. The lower rate of growth of consumer goods imports is consistent with the slower rate of immigration to Israel since 1992 and of immigrants' utilization of their rights. Imports of consumer durables, including vehicles, remained unchanged in 1993. However, the rate at which imports of consumer nondurables imports⁸ rose—from 14 percent in 1992 to 22 percent in 1993—reflects the greater import-intensiveness of nondurables consumption.

The rapid rise of imports of both consumer goods and intermediates (excluding fuel and diamonds) in 1993 reflects a process whereby demand is diverted to imports due to two main factors. First, sharp shifts in demand come up against short-term domestic supply-side rigidities. Second, the greater openness of the economy makes it easier to divert demand abroad.

The increased openness of the economy since 1992 has affected imports as well as exports, though to a smaller extent. Alongside the increase in the volume of imports, the sources and range of items have become more diverse. While the distribution of imports by country of origin did not change significantly (in dollar terms) in 1993, the contribution of nontraditional sources to the increase in imports rose from about 15 percent in 1991 to some 25 percent in 1993. The most impressive growth rates in 1993 were in imports from eastern Europe and Asia excluding Japan—36 and 33 percent respectively—in both of which there was considerable diversification of products.

⁸ The calculation of imported consumer nondurables is based on Table 6.6. Consumer nondurables serve as a proxy for that part of private consumption where imports compete with domestic production, and are estimated as total consumption by households *less* consumer durables, fuel and electricity, housing, and other services.

Restrictions on imports from certain sources, whether for geopolitical reasons or in order to protect domestic production (usually due to the activity of pressure groups), diverts imports to more expensive sources. Once this situation is corrected, as should result from the liberalization of trade, imports will be diverted to cheaper sources and foreign-exchange savings will ensue.

Table 6.7
Import Taxation, Selected Years, 1980-93^a

	(percent)							
	1980	1986	1988	1989	1990	1991	1992	1993
Average tax rate								
Consumer nondurables	20	25	24	23	22	22	24	20
Consumer durables	110	96	99	74	69	67	67	63
Intermediates	5	7	5	4	4	4	4	3
Producer durables								
Machinery and equipment	11	11	10	10	8	7	8	7
Motor vehicles	39	83	73	64	65	54	59	55
Total imports	9	16	16	11	11	11	12	11
Change in average tax rate								
on total imports, due to								
Tax rates		1.7	-4.4	-4.0	-0.8	-1.5	-0.2	-0.8
Composition of imports		5.3	4.4	-1.0	0.8	1.5	1.2	-0.2
Average effective exchange rate								
of all imports		1.72	1.86	2.13	2.24	2.55	2.77	3.14
Coefficient of variation of effective exchange rates		0.24	0.26	0.20	0.21	0.22	0.23	0.22

^a Customs, purchase tax, and other tariffs. The calculations are based on the 28-commodity breakdown of Table 8.10 of CBS, *Statistical Abstract of Israel*.

SOURCE: Based on Central Bureau of Statistics data.

Because of the highly-concentrated nature of both imports and production in Israel, the liberalization of trade brings additional structural benefits, being the main way of increasing competition and minimizing monopoly power. First of all, fear of competition created by liberalization has induced producers and importers to reduce excess profit and hence to lower prices. There is also greater incentive to expand the variety of products, both because new sources have been added and because importers from traditional markets wish to maintain their market share. Greater product variety is one of the principal incentives for the growth of trade, and accounts for the inter-industry trade which accounts for most trade between industrial countries. This inevitably leads to the greater import-intensiveness of consumption and intermediates.

As stated, this process leads to both the reduction of prices and diversification, and hence to more efficient production processes. This change has far-reaching implications for potential growth, diverting investment towards industries with a comparative advantage and utilizing economies of scale.

While Israel's increased openness is due in part to international developments, domestic policy decisions also played a role. In this respect, the most important measure introduced in the last few years was the liberalization of trade, permitting the entry of competing imports from third countries (countries with which Israel does not have trade agreements). This process, which began in September 1991, is to be completed in the year 2000. Another stage was implemented in September 1993, when taxes on imports from third countries were reduced by between 14 and 20 percent.

In the first year of the liberalization of trade (September 1991–August 1992) third countries' share of imports fell from 19 to 14 percent.⁹ In the second year their share rose by only one percentage point. The replacement of quotas by high protective tariffs in the first stage of the program slowed the growth rate of imports from third countries to 9 percent, compared with the 44 percent increase in imports from all sources. The rapid rise in imports from traditional sources indicates the extent to which the program is regarded as a threat to these importers. Despite the gradual reduction of import tariffs, there is as yet no indication that imports are being diverted from traditional sources.

The trade liberalization program, together with the abolition of the 2 percent general levy on imports in July 1993, reduced taxes on imported goods. As Table 6.7 shows, the average tax rate rose in 1992, but fell in 1993 as the tax rate on consumer goods and intermediates—the principal items subject to liberalization—fell below its level in the 1980s. The increase in the tax rate in 1992 was due to the replacement of quotas by tariffs, which began to decline in September 1992.

There has been some retreat in the liberalization of imports of textiles, clothing, and glass, however, and the period during which textiles are to be exposed to competing imports has been extended, in accordance with the regulations associated with the Mandatory Tenders Law.¹⁰

Services account

The surplus on the services account (excluding capital and the administered areas) fell from some \$ 1,420 million in 1992 to about \$ 730 million in 1993. Most of the decline was due to a steep increase in expenditure on tourism services (imports), which rose by some \$ 650 million—38 percent in nominal terms and 28 percent in real terms.

From the slow rate at which tourist expenditure rose in 1991 and most of 1992 it can be inferred that travel abroad was postponed and was implemented in 1993, as the shortfall in consumption was brought into line with disposable wage income—an indication of permanent income. In addition, the travel tax was abolished in January 1993, increasing the attractiveness of vacations in nearby areas relative to internal tourism. Nonetheless, most of the increase in imported tourist services was to distant

⁹ The figures are taken from the annual report of the State Revenue Administration, 1993.

¹⁰ The regulations require that domestic products be preferred to imports for purchases by public corporations, provided the price difference is no greater than 15 percent.

Table 6.8
Capital Imports and the Gap Between Domestic and World Interest Rates, 1990-93

	Quarterly average		1992				Nov '92–	Jan '93–	Mar '93–	Aug '93–
	1990	1991	I	II	III	IV	Dec '92	Feb '93	Jul '93	Dec '93
<i>\$ million</i>										
Nonfinancial private sector										
Implied capital imports	153	129	346	–429	–219	–1,010	–918	–507	815	–41
Current account ^a	–186	–509	–315	–306	–690	–210	–140	–407	–802	–615
Contribution to reserves	–32	–380	32	–735	–908	–1,220	–1,058	–913	13	–656
<i>Interest rates (annualized)</i>										
Overdraft facilities	29.6	29.9	26.1	21.2	21.2	19.4	18.6	19.0	19.3	18.8
Unindexed resident time deposits	14.4	13.9	12.9	11.0	11.0	10.4	10.1	11.0	11.4	9.3
3-month Eurodollar ^b	9.0	7.4	6.4	6.3	6.0	5.5	5.5	5.1	4.6	4.2
Exchange rate ^c			12.4	10.7	8.6	8.7	8.3	6.7	9.2	7.7
Actual devaluation	10.6	13.6	–0.3	–1.6	4.9	12.2	13.3	–1.8	9.0	6.2
Interest gap (asset side)										
Assuming perfect foresight	–5.2	–7.2	6.8	6.3	0.1	–7.3	–8.6	7.7	–2.2	–1.2
Exchange rate ^c			–6.0	–6.0	–3.6	–3.8	–3.6	–0.8	–2.4	–2.7
Interest-rate gap (credit side)										
Assuming perfect foresight	10.0	8.9	20.1	16.5	10.3	1.7	–0.2	15.7	5.7	8.3
Exchange rate ^c			7.3	4.2	6.6	5.2	4.8	7.3	5.5	6.8

^a Although current account data received from the CBS are quarterly, it is assumed here that they are distributed evenly over the quarter.

^b Weighted interest rate on 3-month Eurodollar rate for currencies in exchange-rate currency basket.

^c Slope of band *plus* distance from midpoint.

destinations. On the other hand, the greater increase in the price of foreign travel than in that of internal tourism made it less attractive.

Income from tourist services (exports) rose by 15 percent in nominal terms and 18 percent in real terms in 1993. This is an impressive increase in view of the high level of 1992, and may indicate that world demand for Israel's tourist services is increasing.

Political developments in the region have an immediate effect on income from tourism. From the end of 1987, the *intifada* had a detrimental effect on this export, and the Gulf crisis caused it to plummet, with losses incurred estimated at some \$430 million in 1991. However, tranquillity in the region led to the industry's rapid recovery, so that income from tourism reached record levels. There was a 150,000 (10 percent) increase in tourist arrivals in 1993, mostly from the US and Europe, though since 1992 tourism from Asia has also risen.

Unilateral transfers

In 1993 unilateral transfers fell by \$140 million from 1992, to \$6.7 billion. Private-sector transfers rose by \$180 million, while those of the public sector fell by \$320 million. Most of the decline in the latter was due to an exceptional \$0.6 billion rise in US aid in 1992, following the postponement of half the 1991 civilian aid to 1992. The annual level of transfers since 1991 is in the region of \$7 billion, compared with \$5 billion at the end of the 1980s. Because of Israel's rapid growth rate in recent years, the share of transfers in GDP has fallen from 11.7 percent at the end of the 1980s to 10.5 percent in 1993.

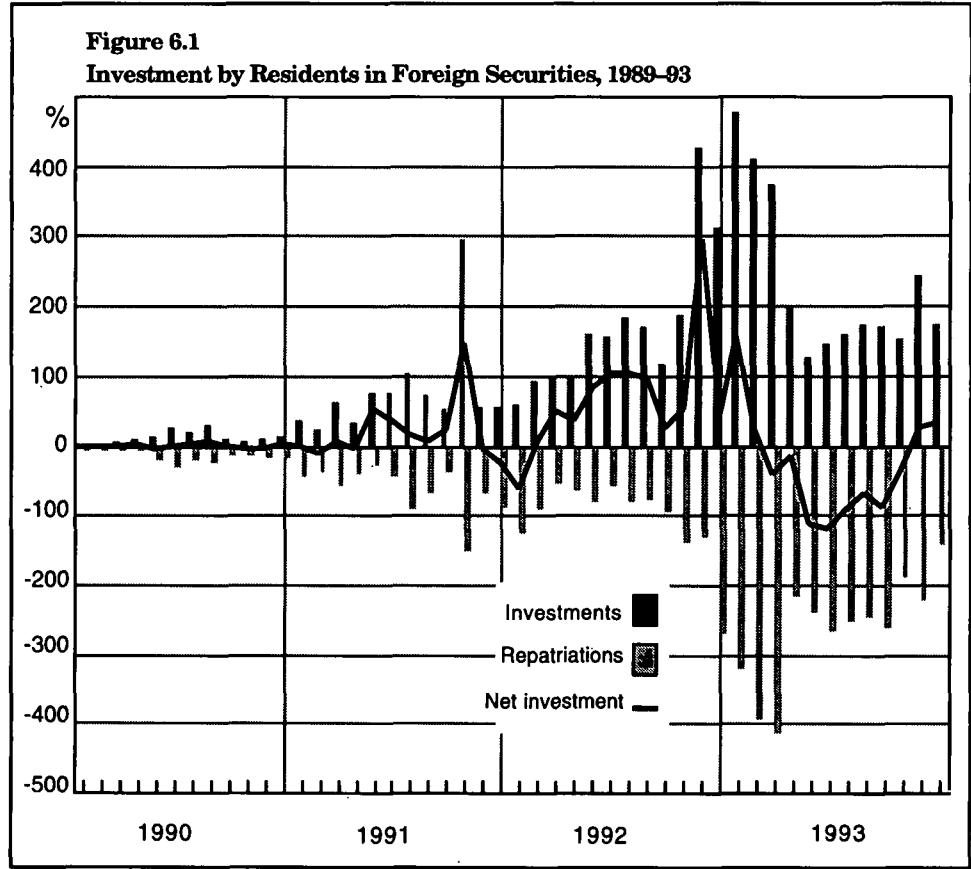
3. THE CAPITAL ACCOUNT

The nonfinancial private sector

The trend of capital movements of the nonfinancial private sector reversed during 1993. In the first few months of the year the considerable outflow of capital, which had begun at the end of 1992, continued, after which there was a capital inflow which persisted even after the monetary expansion of the second half of 1993. Implied private capital imports, which serve as an indicator of nonfinancial private-sector capital movements, amounted to \$0.3 billion in 1992, one third of the capital exports recorded at the end of 1992 (Table 6.8). This trend change is reflected by developments in net financial investment abroad by residents; net investment of almost \$1 billion in 1992 was followed by net repatriation of about \$90 million in 1993 (Figure 6.1).

One result of the liberalization of foreign-exchange control is the structural change in the composition of the nonfinancial private sector's capital movements. In the last few years, since residents were permitted to invest in fixed assets abroad, direct investment

has accounted for a growing share of capital movements. Israeli firms have acquired active companies abroad in order to further their interests by obtaining an overseas marketing base. There does not appear to be any equivalent trend of investment in Israel by nonresidents. If direct investment abroad by residents, which is inevitably long-term, is deducted from the implied capital imports of the nonfinancial private sector, the residue—which is more sensitive to short-term interest rates—amounts to over \$ 1 billion, compared with capital exports of \$ 650 million in 1992.



SOURCE: Report of Controller of Foreign Exchange, 1993.

In view of the extensive monetary expansion of the second half of 1993, the capital inflow is exceptional, since in Israel monetary expansion usually leads to capital outflow. The dominant factor determining investment patterns in general at this time, and capital movements in particular, appears to have been the high expected yield on Israel's stock market.

Capital movements must be examined in the context of the public's portfolio, which comprises a wide variety of domestic and foreign assets. Its composition is based

Capital movements of the private sector

Capital movements in general reflect a number of possibly conflicting considerations, and should consequently be analysed on the basis of their current and capital account components. This is in fact impracticable, both conceptually and statistically, and the various breakdowns—the chief of them being that between the private and public sectors—should therefore be regarded merely as approximations (see note to Table 6.3).

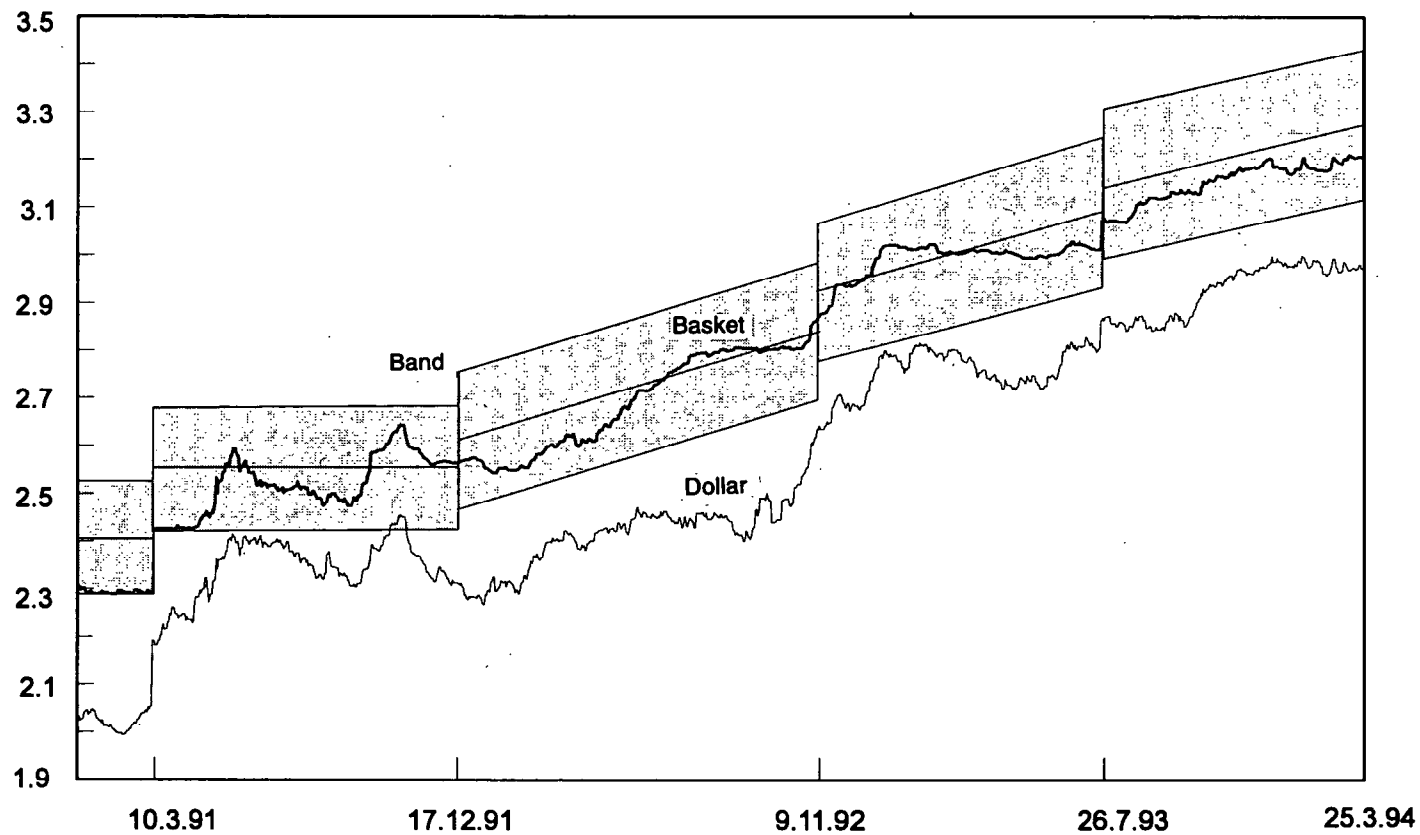
The private sector's capital movements should be reflected by its direct capital imports, as reported in the balance of payments data. However, because of reporting difficulties, this is not the case. An alternative indicator is implied private capital imports, defined as the difference between the contribution of the private sector to the change in the reserves and its deficit on current account. This reflects all the components of the private sector's capital account transactions, and assumes that most of the errors and omissions are due to capital movements.

This indicator reflects the capital movements of both the nonfinancial private sector and the banking system. In Israel these sectors differ as regards objectives and the means at their disposal. Thus, in order to pinpoint the factors behind private sector capital movements it is necessary to make a further distinction between the nonfinancial private sector and the commercial banks for both the capital and the current accounts. The contribution of the nonfinancial private sector to changes in the reserves is defined as the amount of money it purchases from or sells to the Bank of Israel. The current account of the nonfinancial private sector is defined as the private sector current account *less* the items which can be attributed directly to the banks (interest paid abroad or received from abroad). Some transactions of the banking system may, however, serve the nonfinancial private sector, so that this distinction should be regarded as an approximation.

The contribution of the nonfinancial private sector to changes in the reserves can be seen on the trading floor, where the exchange rate of the sheqel against the currency basket is determined daily. Changes in banks' foreign-currency deposits with the Bank of Israel are not implemented on the trading floor, even though they make a significant contribution to the reserves.

primarily on considerations of yield, risk, and liquidity, subject to institutional restrictions. The public's net assets abroad are one of the components of its portfolio. The greater the substitutability between assets, the greater their mutual sensitivity to changes in yield gaps.

Thus, the capital movements of the nonfinancial private sector reflect changes in its portfolio. The expected yield (cost) of assets (liabilities) abroad depends on expected yield abroad and expectations of devaluation, which are affected by monetary—especially exchange-rate—policy. In recent years the substitutability of assets and liabilities in Israel and abroad has increased as a result of both the exchange-rate regime, which has reduced the uncertainty associated with foreign assets or liabilities, and the liberalization of the money and capital markets. This is reflected by the continuing reduc-

Figure 6.2**The Sheqel Exchange Rate Against the Currency Basket and the Dollar, 1991-94^a**^a Weekly data (Mondays), in NIS per \$ or NIS per currency-basket unit.

tion of the gap between interest rates in Israel and abroad. Since 1992 greater substitutability, together with sharp changes in expected relative yields, has resulted in extensive capital movements and portfolio diversification.

The capital movements of the nonfinancial private sector should therefore be examined in the context of monetary and exchange-rate policy and its underlying aims, chief of which is the stimulation of sustainable growth while enabling maximum utilization of Israel's substantial human resources.

Since December 1991 the exchange-rate regime against the basket of currencies has consisted of a midpoint within a sloping band. This system reduces uncertainty regarding expected annual devaluation and moderates the large-scale currency purchases which in the past were associated with large, discrete adjustments of the exchange rate. This required greater coordination between exchange-rate policy (particularly the slope of the band) and interest-rate policy, especially in view of the liberalization of foreign-exchange control in Israel in the last few years. At the end of 1991, regulation of foreign-currency purchases for the purposes of direct investment was reduced, and the terms under which nonresidents could invest in Israel and residents could invest abroad were gradually improved. Exporters' eligibility to hold interest-bearing foreign-currency deposits was expanded, as was the banks' ability to grant foreign-currency credit to the public. Foreign-exchange control permits have not been substantially extended since 1992, although the simplification of the tax regulations on financial investment abroad in mid-1992 led to extensive capital outflow in 1992 and 1993. The altered circumstances of 1993 (see below) led to the reversal of the trend in capital movements, though at a lower level. Significant changes were also evident with regard to capital movements associated with direct investment. Since 1992 fixed investment abroad has soared, as Israeli firms have been able to invest in such assets abroad.

Developments at the beginning of 1993 may be regarded as the continuation of the trend which began at the end of 1992 (Table 6.8). From November 1992 to February 1993 the public bought some \$2 billion from the Bank of Israel—only \$0.5 billion of it for current account financing. Behind these developments lay the central bank's policy in the context of greater liberalization of foreign-exchange control, and the special economic circumstances of that period. In view of the high unemployment rate and lower inflation, the Bank of Israel acted to bring local-currency interest down in 1992, keeping it low during the second half of the year, when foreign-currency purchases rose. Further reduction of interest on the monetary loan (discount window) in November 1992 created an incentive to export capital, along with the change in the slope and position of the sloping band (see Chapter 7).

The extensive capital outflow also reflected the high expected relative yield on investment abroad, in view of interest and exchange-rate developments and expectations that the US dollar would get stronger—a dominant feature of investment at that time. In the last few months of 1992 the central bank refrained from raising local-currency interest, instead permitting the devaluation of the sheqel by 6 percent against the currency basket (and by 8 percent against the dollar), and extensive depletion of the reserves. The

Table 6.9
Investment in Israel by Nonresidents and Investment Abroad by Residents, 1988-93

	(\$ million) ^a					
	1988	1989	1990	1991	1992	1993
1. Investment by nonresidents	419	386	296	587	1,567	...
Traded securities	84	102	45	103	387	...
Direct	320	275	248	508	1,160	815
Bonds ^b	2	3	2	1	3	2
Merchandise	-10	-15	-22	-44	-11	-8
Reinvestment of profit	22	22	22	19	28	27
2. Repatriation of investment by nonresidents	954	281	216	221	727	... ^d
<i>of which</i> Investment in traded securities ^c	855	122	65	88	422	...
3. Net investment by nonresidents	-535	106	81	366	505	721
<i>of which</i> Investment in traded securities	-771	-20	-20	15	-35	167
4. Investment abroad by residents	106	163	346	1,355	2,087	2,985
Direct	84	109	181	428	663	949
Securities	23	54	165	926	1,424	2,035
5. Repatriation of investment abroad by residents	50	122	194	586	510	2,143
6. Net investment abroad by residents	57	41	152	769	1,577	842
<i>of which</i> Investment in traded securities	-5	3	-14	345	926	-86
7. Net investment from abroad by individuals (3-6)	-592	65	-71	-403	-1,072	-121
8. Change in foreign securities held by banks ^e	44	99	358	-83	341	816
9. Total net investment from abroad (7-8)	-636	-34	-429	-320	-1,413	-937

^a Numbers may not add due to rounding.

^b Redemption of independence and development bonds for investment.

^c In 1988 this includes \$800 million redemption of Arrangement bank shares.

^d Data on investment in and repatriation of securities include orders of securities at issue, and therefore do not represent actual purchases and sales.

^e Includes investment in foreign securities by banks.

SOURCE: Based on Central Bureau of Statistics data.

devaluation policy of the end of 1992 may also have contributed to the rise in the expected yield on financial investment. While the rapid and continuous devaluation of the sheqel against the dollar makes foreign-currency purchases more expensive, thus tending to reduce them, at some stage in this complex process it can also generate expectations of further devaluation, raising the expected yield on dollar assets. From January 1993 the sheqel was devalued against the currency basket at a slower rate because of fears of accelerated inflation, and at the same time interest on the monetary loan was raised by two percentage points. As a result of these measures, and in view of the persistent decline in the yield on mutual funds investing principally abroad, the trend of capital movements changed towards the end of February.

From March to July local-currency interest rates were relatively high; during the first four months of 1993 the CPI rose at a rapid annual rate of 17 percent, compared with 13.5 percent in the equivalent period in 1992. The acceleration of inflation beyond the target, and fears of a renewed capital outflow, led policy-makers to maintain interest at the relatively high level of the end of February. In the light of the import of capital at this time, the rate at which the sheqel was devalued against the currency basket was slowed down. Just before the band was shifted, at the end of July, the actual rate was some percent lower than the midpoint.

Towards the middle of 1993 the inflation rate slowed. As a result, and in view of the calm foreign-exchange market and slowdown in economic activity of the first half of the year (due in part to the closure of the administered areas), it was decided to reduce interest and moderate the slope of the exchange-rate band by two percentage points (at the same time raising the midpoint by two percentage points and abolishing both the General Permit for imports and the exchange-rate insurance premium for exporters), setting the inflation-rate target for 1994 at 8 percent.

From August 1993 local-currency interest was relatively low, considering the exceptional expansion of the monetary loan extended to the banks by the Bank of Israel. The main factor determining the public's portfolio at that time appears to have been the expected high yield on the local stock market relative to financial assets abroad, rather than the customary yield gap (the difference between domestic and foreign interest *plus* the expected rate of devaluation). The change in the expected yield in Israel was due to expectations of positive economic developments following the agreement with the PLO in September. This led to a net capital inflow, some of it channeled to domestic shares. Many past increases in domestic share prices were also accompanied by capital inflows.

Price indices for September and October 1993 indicated that there might be difficulties in attaining the inflation target announced in July. Because of this and the exceptional increase in the monetary aggregates, the Bank of Israel acted in December 1993 and in January 1994 to raise local-currency interest, even though the foreign-currency market was quiet at the time. Foreign-currency sales at the beginning of 1994 resulted in only a slight rise in the sheqel exchange rate (relative to the currency basket). Continuous departure from the midpoint could temporarily erode the real exchange rate, as inflationary expectations develop (see Chapter 3).

The turning point in financial investment by residents in 1993 was partly dependent on the increase in capital movements due to direct investment abroad. The latter rose to 950 million in 1993, from \$660 million in 1992, and this was mainly because electronics and communications companies—most of whose output is exported—purchased companies abroad. The object of this was to increase exports by utilizing the existing marketing structures of the companies purchased, as well as to expand activities to allied areas. Underlying the rise in fixed investment abroad by the business sector in the last few years is Israel's rapid economic growth, the liberalization of foreign-exchange control, reduction of red tape, and large-scale issues of securities in Israel and abroad by Israeli companies.

In addition, net investment in Israel by nonresidents rose by \$200 million in 1993, most of it due to the changed trend of investment by nonresidents in quoted securities in Israel. Most of the investment occurred from September to November, apparently also affected by the stock-market boom that followed the signing of the Declaration of Principles by Israel and the PLO. It is still too early to tell whether the net increase in securities investments marks a reversal of the trend of financial investment by nonresidents as a result of progress in the peace process or is a temporary development marking the utilization of good investment opportunities. Be that as it may, investment by nonresidents is still implemented mainly through issues on foreign stock exchanges by Israeli companies. Despite the removal of bureaucratic barriers under the liberalization program, the volume of direct investment in Israel is still relatively low, indicating that progress in the peace process has not yet reached its full economic expression.

the banking system

Since 1992 the banking system has accounted for a large share of total capital movements (Table 6.3), reflecting the change in net liabilities abroad.

The restrictions on the banks differ in essence from those on the nonfinancial private sector, so that their decisions are based on different considerations. The yield gap, which underlies the decisions of the nonfinancial private sector, is virtually nonexistent for the banks. This is mainly because of the requirement that the banks maintain almost full parity between their foreign-currency assets and liabilities.

Banks' resources which have become available abroad since 1992, following the reduction of the reserve requirement on restitutions deposits, have been redirected. Because of the dearth of profitable uses in Israel, the banks increased their overseas assets in 1992, resulting in the depletion of the reserves by \$1.3 billion. At the beginning of 1993, by contrast, the net capital import of the banks amounted to \$600 million, and was used to increase their deposits in excess of reserve requirements with the Bank of Israel. The direction of banks' capital movements reversed at the beginning of 1993, after the Bank of Israel offered interest on deposits in excess of the reserve requirement that was slightly higher than that paid abroad, but later in the year this rate

was reduced. Towards the end of 1993, as the volume of the monetary loan rose steeply, a problem of collateral arose, impelling the banks to expand their deposits in excess of the reserve requirement once more; during this period, too, some sources came from the reduction of foreign assets.

In spite of the decline in banks' total assets abroad, their foreign bond holding continued to rise in 1993, increasing by \$0.8 billion. Their overseas investment consisted mainly of securities, whose risk level is equal to that of interbank deposits but have a higher yield. Thus, a decline in banks' deposits overseas reflects both the change in the composition of their portfolio abroad and their redistribution of sources between deposits in excess of the reserve requirement with the Bank of Israel and foreign investment, in the context of yield gaps between the various components.

The public sector

There were two principal channels of net borrowing by the government in 1993—Treasury bonds of \$2 billion issued within the framework of the US government guarantees, and State of Israel Bonds to the value of \$1.1 billion. At the same time, the flow of net loan receipts from other foreign governments and banks ended. In March and September the government of Israel issued tradable bonds under the guarantee of the US government. Slightly over half of this issue was for an average of 6–7 years, and the rest for 20 years. The average effective cost of all the issues was 7.5 percent in March and 6.8 percent in September.

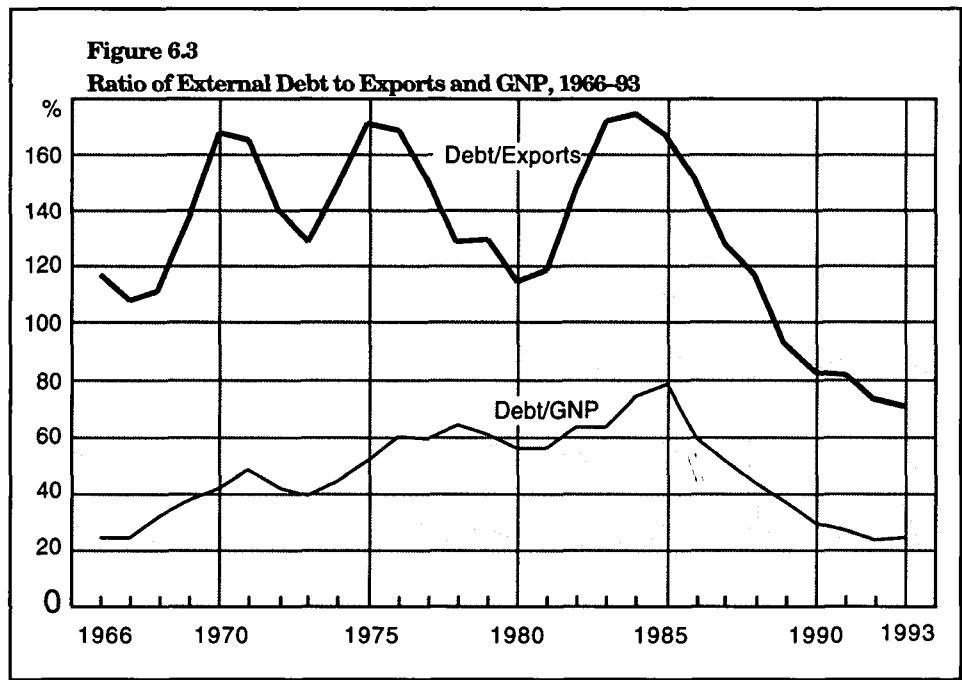
Net borrowing by means of State of Israel Bonds constitutes an important element of public sector capital movements. Since 1991 some \$3.2 billion has been borrowed through this channel, and when repayment is deducted, this came to a net \$1.9 billion.

In the last few years net loans from foreign governments and banks have constituted an additional source of foreign currency. In 1991–92 the net average annual amount borrowed from these sources was about \$170 million, while in 1993 there was no repayment of \$60 million. This trend change reflects some degree of substitution in the composition of government borrowing resulting from the US government loan guarantees.

4. THE EXTERNAL DEBT AND THE RESERVES

Israel's net external debt rose by some \$0.6 billion in 1993, reaching \$15.7 billion compared with \$15.2 billion in 1991 and 1992 (Table 6.10). This increase was reflected by a trend change in the net debt/GNP ratio, which rose by 0.7 percentage points to 24. percent. The larger debt/GNP ratio followed a continuous and rapid decline since the 1985 economic stabilization program (ESP), which persisted into the 1990s, when mass immigration was absorbed. During the year the gross external debt rose by some \$1.

billion, primarily because of an increase in the long-term government debt due to the \$ 2 billion borrowed under the guarantee of the US government.



SOURCE: Based on Central Bureau of Statistics data.

In the framework of the guarantees Israel can borrow another \$ 7 billion in the next few years.¹¹ This credit framework, which is a convenient and stable source of finance, led to further improvement in Israel's risk rating. The direct effect of the guarantees on the size of the gross debt depends on the extent of substitutability between them and other sources of finance. In 1993 the government chose to utilize only some of its traditional credit lines. The increase in sources of foreign currency available to Israel as a result of the guarantees may lead to a decline in borrowing abroad by the private sector. This will be determined by the gap between the price of capital facing it in Israel and abroad.

Israel's external debt/GNP ratio is still relatively low, and the fact that it rose in 1993 does not indicate any inability to pay debts. Israel's ability to repay them in the future depends on the way sources are allocated. Data from the last few years show a high level of investment in the principal industries, and the increased capacity thus created will ease repayment. Furthermore, the debt/GNP ratio gives only part of the picture, as it reflects neither the composition of the debt as regards duration and borrower nor the unique character of the guarantees.

¹¹ In March 1994 Israel borrowed about \$ 1 billion.

Table 6.10
Assets and Liabilities in Foreign Currency, 1989-93^a

	(\$ million)				
	1989	1990	1991	1992	1993
Gross liabilities^b	31,522	31,476	32,781	33,206	33,631
Banking system assets	6,775	7,428	8,317	8,897	10,665
Total liabilities^b	24,746	24,048	24,464	24,309	22,967
<i>of which</i> Government	16,519	16,511	16,641	17,247	18,058
Nonfinancial private sector	4,299	4,304	4,611	4,305	3,814
Banking system, net	3,928	3,232	3,212	2,757	1,095
Foreign reserves	5,330	6,316	6,298	5,131	6,385
Exporters' credit to foreigners	838	600	557	534	669
Net liabilities^b	15,665	15,122	15,175	15,229	15,693
Current debt					
Banking system (short term)	1,138	1,204	2,573	2,728	1,256
Nonfinancial private sector (short term)	1,401	1,418	1,554	1,393	1,074
Direct government debt (short term)	101	0	0	0	0
Medium and long-term debt repayable within a year	1,572	1,894	1,806	1,850	1,785
Total current debt	4,211	4,516	5,933	5,971	4,115
Net current debt^c	-1,954	-3,224	-2,868	-2,817	-3,745

^a Differences in totals are due to rounding.

^b The data for liabilities in this table are consistent with those published by the Central Bureau of Statistics. The data published by the Controller of Foreign Exchange are slightly different because they were revised on different dates.

^c Total current debt less foreign reserves, assets in other financial institutions, and exporters' credit to foreign customers.

SOURCE: Based on Central Bureau of Statistics data.

The principal debtor is the public sector, which is generally regarded as being less risky than the private sector. The public sector's share of the debt has been rising since 1988, and at the end of 1993 reached 78 percent. In 1993 medium- and long-term debt accounted for 88 percent of Israel's external debt, similar to its share in 1990-91.

The average cost of the debt has continued to decline since 1990, largely reflecting the worldwide reduction in interest rates. The relatively low rate of interest on the private sector's medium- and long-term debt in comparison with that on the government's debt is due primarily to differences in the duration of the credit, since government debt borrowing is for longer periods.

At the end of 1993 the reserves amounted to \$6.7 billion, compared with \$5.3 billion at the end of 1992, though the annual average was \$0.7 billion lower. In addition to fluctuations in the level of the reserves in 1992-93, there have been sweeping changes in the composition of their sources. Before the reserve requirement on restitution deposits was reduced, it accounted for much of the 'hard core' of sources, because of the high reserve ratio and the relative stability of the public's restitution deposits in commercial

Table 6.11

The External Debt Burden, 1988-93^{a,b}

	1988	1989	1990	1991	1992	1993
<i>million</i>						
Interest payments on net external debt	-2,509	2,514	2,608	2,418	2,314	2,202
Interest receipts on foreign-currency assets	963	1,235	1,590	1,616	1,421	1,052
Net interest payments on external debt	1,546	1,278	1,018	802	893	1,150
Other capital services						
Debit	134	159	168	139	211	194
Credit	33	34	18	46	-11	-10
Repayment of principal	6,555	2,262	1,812	2,214	1,865	1,943
Total net debt servicing	3,424	2,942	2,979	3,110	2,980	3,297
<i>percent</i>						
Net interest/net external debt ^c						
Nominal	9	8	7	6	6	7
Real ^d	5	3	4	3	3	4
Interest/income at disposal of economy ^e	3	3	2	1	1	2
Net interest/exports ^f	11	8	6	5	5	5
Net debt servicing/exports ^f	24	19	18	18	15	16
Net debt servicing/(exports ^f + transfers ^g)	18	14	13	13	11	12
Net debt servicing/GNP	8	7	6	5	5	5

^a Figures may not add due to rounding.

^b Net debt servicing figures for 1988-93 are net of conversion of the debt to the US government.

^c The denominator is the debt lagged six months.

^d The nominal figure (preceding line) deflated by the rate of inflation in industrialized countries (5-year average), as an indicator of long-run inflationary expectations.

^e GNP (in dollars) *plus* net unilateral transfers.

^f Exports f.o.b., excluding capital services.

^g Net unilateral transfers.

SOURCE: Based on Central Bureau of Statistics data.

anks. The gradual reduction of the reserve requirement released large foreign-currency sources which can henceforth be allocated as the banking system sees fit. This decision is based, *inter alia*, on the interest offered on these deposits by the Bank of Israel. In 1993, for example, when the interest on these deposits was raised, the banks increased their deposits with the Bank of Israel in excess of the reserve requirement (see Chapter 7).