Chapter 6
The Balance of Payments

The deficit on the current-account balance of payments rose to $ 4.9 billion in 1996, despite the improvement in the terms of trade and the marked moderation of world prices. This deficit resulted from the large budget deficit and the continued relatively rapid rise of private-sector domestic demand alongside the slower increase in supply. In part this reflected a slowdown in the growth rate of factors of production, and in part a decline in profitability, especially in the traded sector. Excess demand was expressed primarily in the rapid increase in imports—beyond that deriving from the composition of uses of resources—as well as in the continued decline in exports of the 'traditional' industries, whose profitability is low. By contrast, exports of high-tech industries continued to grow rapidly. Exports of tourism services plummeted due to security incidents at the beginning of the year.

The balance-of-payments deficit was financed by continued short- and long-term capital inflow in 1996, alongside a considerable increase in the foreign-exchange reserves. The extensive flows of long-term capital during the last two years are connected with Israel's improved risk rating and international standing in view of the US government loan guarantees and progress in the peace process. Large-scale private short-term-capital inflow continued, principally because of the yield differential between Israel and abroad. At the same time, the net external debt/GDP ratio continued to fall, reaching the relatively low level of about 21 percent.

1. MAIN DEVELOPMENTS

The deficit on the current-account balance of payments reached $ 4.9 billion, compared with $ 3.9 billion in 1995 (5.1 percent ofGDP in 1996 compared with 4.5 percent in 1995).[1] The deficit widened in 1996 after growing appreciably in 1994 and

The deficit on the current-account balance of payments rose to $ 4.9 billion.

[1] The calculation is based on nominal GDP *divided by* the annual average exchange rate. A calculation based on National Accounts figures at constant prices, on the other hand, indicates that as a proportion of GDP the current-account deficit and the import surplus rose more markedly. The difference is due to real appreciation.

1995, continuing the trend evident since the influx of immigrants began (at the end of 1989) (Figure 6.1). The deficit grew despite both the improvement in the terms of trade in 1996 (after two years in which they had deteriorated) and the moderation of dollar prices of imports and exports. The large current-account deficit that accompanied the substantial public-sector deficit made policy-makers realize that fiscal restraint would be necessary in 1997.

The deficit was financed by capital inflow, alongside an appreciable rise in the foreign-exchange reserves.

In 1996 the current-account deficit was financed by continued short- and long-term-capital inflows, allowing a significant build-up of the foreign-exchange reserves. The risk endemic in an ongoing current-account deficit such as prevailed in 1996 is that economic stability will be undermined, as the cost of financing it can rise significantly, placing a heavy burden on the economy. This will be the case especially when the US government guarantees come to an end. Note in this connection that capital flows, especially short-term ones which are sensitive to yield differentials, can change direction rapidly. Nonetheless, the foreign debt/GDP ratio continued to fall in 1996, and the relatively low level of 21 percent diminished the threat to economic stability.

The increase in the import surplus reflected moderation of the rate at which domestic demand grew and a faster decline in the expansion of supply.

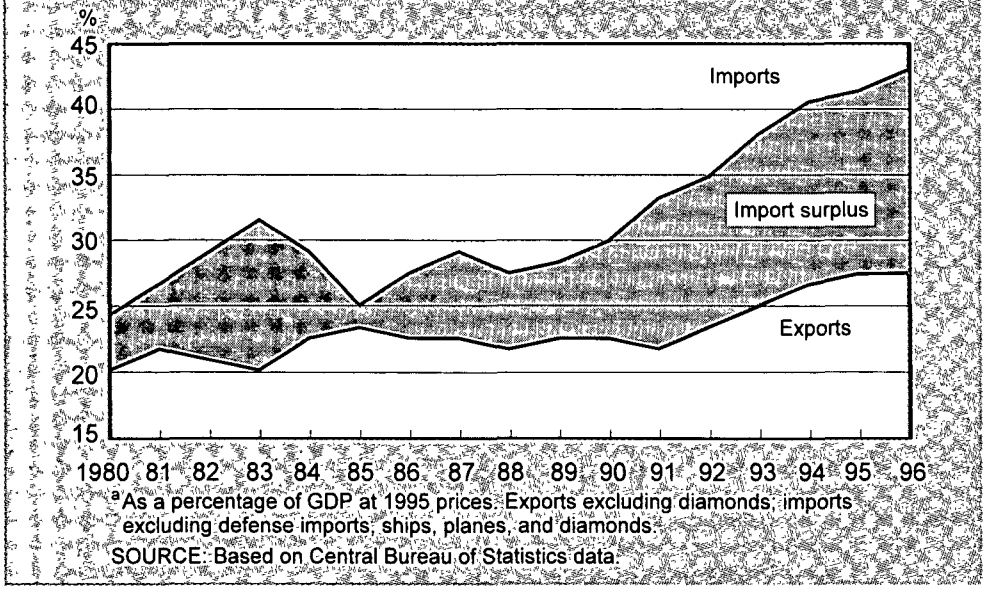
The import surplus rose from $ 11.1 billion in 1995 to $ 12.9 billion in 1996.The rise reflects some easing of the rate at which domestic demand expanded, and the slowing of the growth of aggregate supply. The fact that GDP growth declined beyond the moderation in demand reflected a 0.7 percentage-point fall in the share of national saving in GDP (due to the decline in public saving) and the stability of the share of investment in GDP, so that the gap between them widened slightly. The widening on

Table 6.1
Financing the Current Account, 1990–96

($ billion)

	Average 1990–93	1994	1995	1996
Current account	−0.2	−2.3	−3.9	−4.9
Total import surplus	−6.8	−9.3	−11.1	−12.8
Civilian import surplus	−5.0	−7.8	−9.8	−11.0
Exports	20.7	25.5	29.8	31.3
Civilian imports	25.7	33.3	39.6	42.2
Unilateral transfers	6.6	7.0	7.3	7.9
Financing				
Long-term capital flows	0.5	2.9	2.3	4.4
Short-term capital flows	0.3	0.0	0.6	2.2
Capital flows of banking system	−0.3	−1.3	1.0	−0.5
Errors and omissions	−0.2	0.8	1.2	2.2
Rise (−) in foreign-exchange reserves	−0.1	0.0	−1.2	−3.5

Figure 6.1
Imports, Exports, and the Import Surplus,[a] 1980-96



[a] As a percentage of GDP at 1995 prices. Exports excluding diamonds; imports excluding defense imports, ships, planes, and diamonds.
SOURCE: Based on Central Bureau of Statistics data.

the import surplus reflected a considerable volume increase in imports of goods and services alongside a slight decline in prices, and the slower rate at which exports rose together with a slight rise in prices.

Merchandise imports, which were particularly high in the first quarter of 1996, moderated slightly in the second, and then stabilized at a moderate level for the rest of the year. Merchandise exports, which grew relatively modestly until the third quarter, rose markedly in the last. These trends were expressed in the significant improvement in the balance of trade in the second half of the year. The improvement in the goods and services account was smaller because of the continued decline in exports of tourism services.

The extent of the current-account deficit, which has averaged 4.8 percent of GDP in the last two years, was due to the relaxation of fiscal restraint—reflected in an increasing deviation from the domestic budget deficit—combined with a relatively high level of domestic demand by the private sector. This occurred even though immigration declined in those years, and the initial stage of immigrant absorption, which is investment-intensive (especially in housing), came to an end. Excess domestic demand, together with contractionary monetary policy and extensive capital inflows, led to real appreciation, expressed in lower profitability in the traded sector. This also had an adverse effect on aggregate supply, contributing to the expansion of the balance-of-payments deficit. This adverse effect was expressed primarily in the rapid rise of imports—beyond what was required by the composition of uses of resources (assuming a constant import component)—and by the decline in some export industries, especially

the traditional ones whose profitability is low. Exports of the product of high-tech industries continued to expand rapidly, however.

The security incidents at the beginning of the year and the consequent lengthy closure mainly harmed exports of tourism services.

The security incidents at the beginning of the year and the consequent lengthy closure of the Autonomy and the administered areas harmed both imports and exports. Exports of tourism services plummeted and labor services imported from the Autonomy and the administered areas were replaced by labor services from abroad. Imports of goods from the Autonomy and the administered areas also plunged (though it is reasonable to assume that to some extent they were replaced by imports from other sources).

Capital inflow in 1996 exceeded the current-account deficit financing requirement, and the foreign-exchange reserves rose to stand at more than $ 11 billion at the end of 1996.

Capital inflow was significantly higher in 1996 than the balance-of-payments deficit financing requirement, and was expressed in a $ 3.5 billion increase in the official foreign-exchange reserves,[2] which were more than $ 11 billion at the end of 1996. As a result, implied capital imports[3] were over $ 8 billion in 1996 compared with about $ 5 billion in 1995. Since 1993 long-term capital inflows have grown appreciably as a result of the increased capital inflow of the public sector in the wake of the US government loan guarantees. Since 1995 the capital inflow of the private sector has risen markedly also due to Israel's improved credit risk rating and international standing in view of peace process, the US guarantees, and the general expansion of investment in emerging economies. Short-term capital inflow of the nonfinancial private sector remained consistently large, mainly due to yield differentials on the domestic and foreign markets as a result of the relatively high interest rate maintained by the Bank of Israel throughout the year. Capital inflow in 1996 over and beyond the current-account deficit financing requirement was reflected by excess supply of foreign currency for most of the year. This exerted downward pressure on the exchange rate, after the Bank of Israel confined its intervention in the foreign-exchange market to defending the borders of the exchange-rate band.

[2] Some of the US aid for 1995—$ 950 million—was received only at the beginning of 1996 instead of at the end of 1995. The change in the reserves in 1996 includes this aid. If the aid had been received on time, the reserves would have risen by an additional $ 950 million in 1995 (an increase of $ 2.2 billion instead of $ 1.2 billion) and the increase in 1996 would have been smaller by that amount. Since the unilateral transfers item of the current account includes the aid as if received when due, the short-term capital exports item was adjusted so that the actual state of the reserves could be recorded. Accordingly, the capital exports of the government—$ 950 million—were recorded as at the end of 1995, and short-term capital imports of the same amount were recorded at the beginning of 1996. These adjustments did not affect the basic and current-account deficits. The actual development of the foreign-exchange reserves affected the calculation of implied capital imports in 1995 and 1996 and the foreign debt in 1995.

[3] Implied capital imports are the sum of the current-account deficit and the rise in the official foreign-currency reserves.

2. THE CURRENT ACCOUNT

General review

The widening of the import surplus reflects the continued rapid volume increase in imports and moderation of export growth.

The current-account deficit widened in 1996—to $ 4.9 billion—as a result of the $ 1.7 billion increase in the import surplus, accompanied by an $ 0.5 billion rise in unilateral transfers. The increase in the import surplus reflects the continued rapid rise in the volume of imports and relative moderation of export growth. The relative stability of import and export prices and the improvement in Israel's terms of trade tended to reduce the expansion of the import surplus. Imports of consumer goods, both durables and nondurables, continued their marked volume rise, while imports of intermediates (excluding fuel and diamonds) moderated somewhat. Export growth slowed, with a steep drop in exports of tourism services and a decline in exports of most of the traditional industries; despite the latter there was a 7 percent rise in the volume of total industrial exports. Exports of high-tech industries, by contrast, rose steeply—by between 15 and 20 percent (Tables 6.A.4 and 6.A.5, and Figure 6.3).

The volume of industrial exports increased by 7 percent.

Developments on the current account should be reviewed in the context of the exogenous conditions facing Israel's economy, the security and geopolitical situation, and macroeconomic factors. Changes in the wider economic background were mixed in 1996, and although world trade expanded more slowly, it still grew relatively rapidly. Israel's terms of trade improved, after two years in which they had deteriorated. World trade prices declined slightly, after rising considerably in 1995, and this acted to reduce the import surplus. The security incidents in the second quarter of the year harmed exports, however, as did the uncertainty with regard to political developments; exports of tourism services were particularly hard hit.

Israel's terms of trade improved, after two years of deterioration.

The improvement in Israel's terms of trade was due principally to the strengthening of the dollar (by 8 percent against the 4-currency basket[4]), which accounts for a larger proportion of Israel's exports than of imports. The 3 percent decline in world prices of manufactured goods, considerable increase in the price of fuel, and slight (0.7 percent) rise in world prices of raw materials acted to worsen Israel's terms of trade, since it imports raw materials and exports manufactured goods. However, prices of imported intermediates, with the exception of fuel and diamonds, fell by about 3 percent (*inter alia* because of the liberalization of trade).[5]

The widening of the current-account deficit to 5 percent of GDP in 1996 reflects the import surplus, which has been rising in the last few years. At the beginning of the 1990s it increased at an acceptable rate in view of the increased investment demand

[4] The German mark, pound sterling, French franc, and Japanese yen, in accordance with their weights in the basket of currencies excluding the dollar.

[5] The effect of the liberalization of trade on prices of imported intermediates is insignificant, as to a great extent they were exempt from tariffs in the past, too.

Table 6.2
Background Conditions, 1990–96

(rate of change, percent)

	Average 1990–93	1994	1995	1996
World trade[a]				
Quantitative expansion				
Goods and services	4.4	8.8	8.9	6.7
Goods	4.6	9.5	9.1	6.4
Prices ($)	1.8	2.5	8.8	-0.7
Terms of trade	1.1	-2.2	-5.0	1.7
Export prices[b] ($)	2.8	-0.4	4.9	0.3
Import prices[b] ($)	2.2	1.9	10.2	-1.4

[a] SOURCE: IMF, *World Economic Outlook*, October 1996.
[b] Excluding capital services and diamonds.

In the last two years the increase in the deficit has mainly reflected a decline in the national saving rate.

required for the absorption of the large-scale immigration. If it remains high, however, this could undermine economic stability, especially since in the last two years the rise in the deficit has primarily reflected the decline in the national saving rate (i.e., a rise in consumption), while the share of investment has remained stable. Domestic demand continued to grow quite rapidly in 1996 while supply expanded more moderately, so that the excess domestic demand led to a large current-account deficit. It is impossible to tell on the basis of changes in the composition of demand whether domestic demand crowded out exports in 1996. The slower rate of export growth reflected mainly a sharp drop in exports of tourism services as a result of exogenous factors—the security incidents at the beginning of the year—whereas the growth rate of merchandise exports (excluding diamonds and exports to the Autonomy and the administered areas), and specifically of manufactured goods, accelerated. On the other hand, the volume rise in imports exceeded expectations based on the increase in domestic use of resources (assuming constant coefficients), and this is consistent with the decline in their relative price, i.e., real appreciation (Chapter 2).

The real exchange rate (defined as import or export prices divided by the implicit price index of GDP), which has been appreciating continuously since the mid-1980s, continued to do so—by 6 percent—in 1996, some 2 or 3 percent above the annual average in the 1990s (Table 6.3).[6] Part of the real appreciation of recent years was due

[6] The index of prices of tradable goods *divided by* the index of prices of nontradable goods, based on the CPI, as cited in Chapter 3, indicates that real appreciation has been far more moderate—3 percent. The real exchange rate, which is calculated on the basis of the exchange rate adjusted for differences in inflation between Israel and its trading partners, also indicates that real appreciation was lower—3 percent for consumer prices and 5 percent for wholesale prices.

Table 6.3
Relative Prices and Exchange Rates, 1991–96

(rate of change, percent)

	Average 1990–93	1994	1995	1996
Import prices ($)	−1.5	2.2	8.4	−0.5
Export prices ($)	0.3	−0.9	4.5	0.6
GDP prices [a]	14.8	12.3	9.2	11.2
Real exchange rates				
Import/GDP prices	−5.3	−4.6	0.3	−6.9
Export/GDP prices	−3.5	−6.1	−4.1	−4.6
Tradables/nontradables prices	−4.5	−6.2	−3.1	−3.2
Exchange rates (annual averages)				
NIS/dollar	12.0	6.4	0.0	5.9
NIS/currency basket	11.5	7.8	4.6	3.5
Dollar/4-currency basket 4[b]	0.7	−2.8	−5.0	8.0

[a] Implicit price index.

[b] The German mark, pound sterling, French franc, and Japanese yen, in accordance with their weights in the basket of currencies excluding the dollar.

to long-term factors characteristic of growing economies with a similar level of income—a rise in the relative demand for nontradables and the diversion of supply towards tradables as a result of the faster increase in their productivity. It is more difficult to explain the pace of appreciation in 1996, however, when construction demand slowed substantially (in previous years the surge in demand in this industry and the rise in its prices accounted for some of the real appreciation). The moderation of prices abroad and the macroeconomic policy mix—expansionary fiscal policy and the monetary restraint adopted in order to attain the inflation target—played an important role in generating real appreciation in 1996 (Chapters 1 and 2). In dollar terms, prices of imports fell by 0.5 percent, with those of imported intermediates rising by the same amount. Export prices rose by 0.5 percent, whereas the implicit price index of GDP rose by about 12 percent, similar to its annual rate since 1992. Thus, the moderation of world prices together with only slight nominal depreciation was not translated into the moderation of the implicit price index of GDP. This lack of response is not fully explained by excess demand, especially in view of the relatively elastic supply of foreign workers in the untraded sector. It seems, therefore, that some of the explanation lies in nominal rigidities, i.e., a persistent increase in the implicit price index of GDP, at the same rate as the average of the last few years (see Chapter 3).

Part of the real appreciation is explained by long-term factors and nominal short-term rigidities.

Given the expansionary fiscal policy, would a less contractionary monetary policy—with its attendant faster nominal depreciation—have reduced the rate of real appreciation? If real appreciation largely expresses real forces—mainly the size and composition of demand—the acceleration of nominal depreciation will have only a small and temporary effect on real depreciation,[7] especially when the economy is approaching full employment. However, the relatively elastic supply of foreign workers, especially in the nontraded sector, weakens the contention that the economy is approaching full employment. In addition, a less contractionary monetary policy would have been reflected by faster expansion of domestic demand, leading to an even larger current-account deficit and greater deviation from the inflation target. Nonetheless, if prices are determined on the basis of expected depreciation in accordance with the slope of the band, faster depreciation (i.e., steeper than the expected rate) would have relatively little effect on prices, and real short-term appreciation would have been smaller.

As stated, the real appreciation of 1996, continuing the trend of the last few years, expresses the moderation of import and export prices relative to domestic prices and consequently serves as one of the indicators of the persistent erosion of the profitability of exports and import substitutes vis-à-vis the production of nontradable goods. However, the export trends of various industries indicate that hardest hit were those with relatively low profitability (the traditional industries), i.e., those less able to absorb further erosion of their profit margin. High-tech industries, on the other hand, continued to expand rapidly, despite real appreciation, the main constraint to even faster growth being the lack of skilled workers, particularly specialized engineers and technicians. The fact that the traditional industries export mainly to Europe whose currencies became weaker, whereas the market for high-tech exports is in the dollar bloc and the dollar gained strength in 1996, also helps to explain the different trends of these industries.[8] Note, however, that the circumstances that served to moderate the effect of real appreciation on some components of exports will not necessarily persist, and the ability to absorb the erosion of the profit margin resulting from appreciation is limited. Consequently, if appreciation continues its effect will be felt

The exports of the traditional industries were hardest hit, while high-tech industries continued to expand rapidly.

[7] Leora Meridor and Shula Pessach, "The Real Exchange Rate in Israel: a Long-Run Perspective," *Economic Quarterly*, August 1995, pp. 284–317 (Hebrew); Akiva Offenbacher, Michael Beenstock, and Yaakov Lavi, *A Macroeconomic Model for Israel for 1962–90, a Market Equilibrium Approach to Aggregate Demand and Supply*, Bank of Israel Discussion Paper 92.07, 1992 (Hebrew).

[8] In 1995 some 50 percent of the exports of traditional industries (food, beverages, tobacco, textiles, clothing, leather and its products, paper and its products, and print and publishing) went to the EU countries and 27 percent to the US. Some 28 percent of the products of high-tech industry, on the other hand, was exported to Europe and 34 percent to the US.

more fully in the future. In addition, further rapid and sustainable economic growth must be based on the expansion of exports, deriving from economies of scale. Exports can serve as the engine of growth, however, only if macroeconomic conditions, including fiscal restraint, stimulate their growth and ensure profitability, enabling them to compete on world markets.

In 1996 the relative profitability of exports was also affected by the relative fall in the price of imported intermediates, which play a larger role in production for export than for the domestic market. Another index of industrial export profitability is unit labor cost.[9] The 4 percent rise in this index in 1996, after 8 percent in both 1994 and 1995, indicates that erosion of the profitability of industrial exports is continuing. Note, however, that this index is an aggregate, comprising industries which differ from one another (see next section and Section 6 in Chapter 2).

Alongside the indicators that profitability has fallen, some factors which are not captured in them have boosted exports. These include the opening up of new markets, the significant growth of capital stock, and—less directly—the liberalization of trade. The latter contributes to the long-term expansion of exports in two ways. First, it encourages firms in the traditional industries to become more efficient, enabling them to compete in international markets in the future, and secondly it facilitates penetration of new markets by establishing trade contracts with them. The growth of exports to Asian countries, imports from which have risen appreciably in the last few years, indicates that this process has begun.

The liberalization of trade encouraged firms in the traditional industries to become more efficient, and facilitated the penetration of new markets.

Merchandise exports

Merchandise exports expanded by 6.8 percent in 1996, after increasing by 9.3 percent in 1995. Excluding diamonds and exports to the Autonomy and the administered areas, the rise was 8.5 percent, after 4 percent in 1995. Industry exports (excluding diamonds and exports to the Autonomy and the administered areas) increased by 7.3 percent, compared with only 3.5 percent in 1995. Agricultural exports soared—by 23 percent—while their price declined by 12 percent (Tables 6.4 and 6.A.4, and Figure 6.2).

Merchandise exports rose by 6.8 percent.

The export trends of the principal industries varied (Tables 6.4 and 6.A.5). Exports of the traditional, unskilled-labor-intensive industries plummeted, while those of high-tech, export-oriented industry continued to expand apace. As the trend towards

[9] Note that this index is based on the real labor costs and productivity of industry as a whole, and not only of export industries. In addition, the price of export product is an estimate derived from output prices, an assumption as to the share of inputs (some 40 percent), and the postulate that the prices of inputs for export production behave in the same way as those of inputs for manufacturing industry as a whole.

Table 6.4
Merchandise Exports, 1991–96

(rate of change, percent)

	Volume				Distribution
	Average 1990–93	1994	1995	1996	1996
Total net merchandise exports[a]	11.1	15	9.3	6.8	100
Total excl. diamonds, etc.[b]	13.6	13.5	4.0	8.5	67.8
Industry excl. diamonds, etc.[b]	15.1	13.9	3.5	7.3	64.3
of which Textiles, clothing, & leather	8.5	8.1	3.5	–4.0	4.9
Metals, machinery, electronic and electrical equipment	19.1	15.4	0.3	13.2	34.0
Agriculture	1.0	12.0	16.9	23.1	3.9
Processed diamonds	5.1	22.3	8.4	2.5	20.2
Raw diamonds	22.0	35.7	41.1	15.6	4.1
Merchandise exports to Autonomy and administered areas	3.8	–0.1	61.6	0.2	8.0

[a] According to balance-of-payments figures.
[b] Excluding diamonds, and exports to Autonomy and administered areas.

With growing globalization, the traditional industries found it increasingly difficult to compete on world markets.

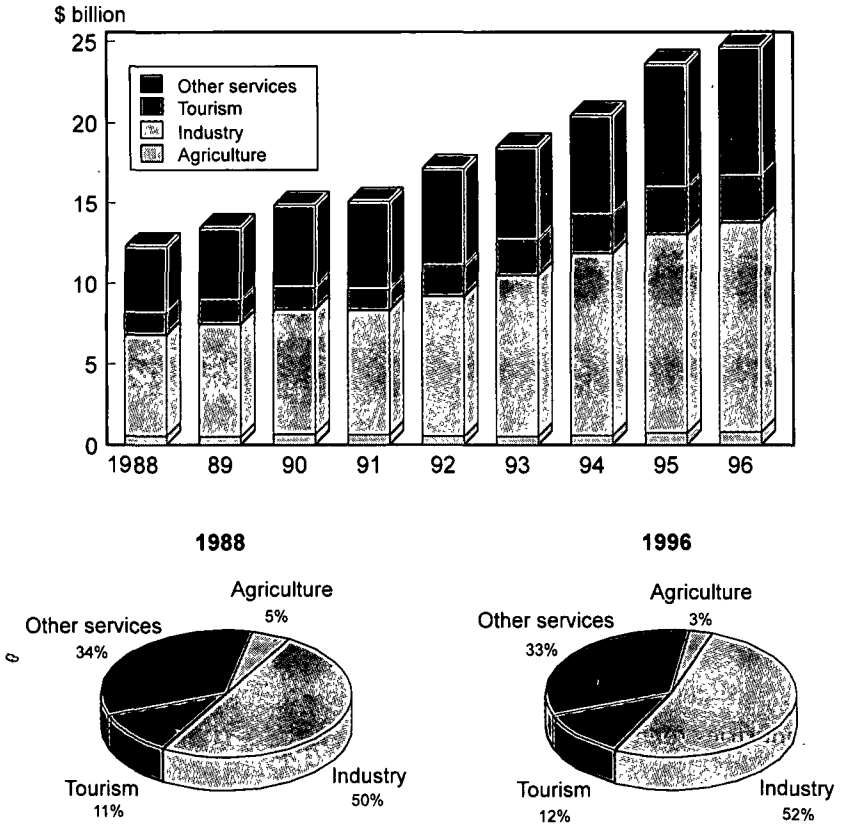
globalization persisted—with lower trade tariffs and the removal of barriers—the traditional industries found it increasingly difficult to compete on world markets, so that the preferred status of Israel's exports declined vis-à-vis countries with which it does not have trade agreements (the explanation for the fall in Israel's textile exports to the US in 1996 is thought to be the effect *inter alia* of the NAFTA trade agreement granting Mexico preferred status). This problem was exacerbated by the considerable rise in labor costs, especially of unskilled labor, arising from the Minimum Wage Law, as the share of workers earning the minimum wage is relatively high in these industries.[10] The relative weakening of the European currencies and the large share of exports to Europe of these industries also harmed their competitiveness.[11]

High-tech industries accounted for 34 percent of industrial exports in 1996 (Figure 6.3). Its rapid growth reflects its reliance on one of Israel's main comparative

[10] Very few foreign workers are employed in manufacturing, in contrast to other industries, so that they had relatively little effect in reducing the wages of unskilled manufacturing workers.

[11] Production for the domestic market by these industries also suffered as a result of the liberalization of trade. Some mixed firms (producing for both the domestic market and for export), in which production for the domestic market plays a large part and whose exports were also adversely affected, may close. The harm caused to exports by this is limited, however, as most exports are from firms producing mainly for export. In addition, in industry in general, and in mixed firms in particular, production may be diverted to export.

Figure 6.2
Composition of Goods and Services Exports,[a] 1988-96



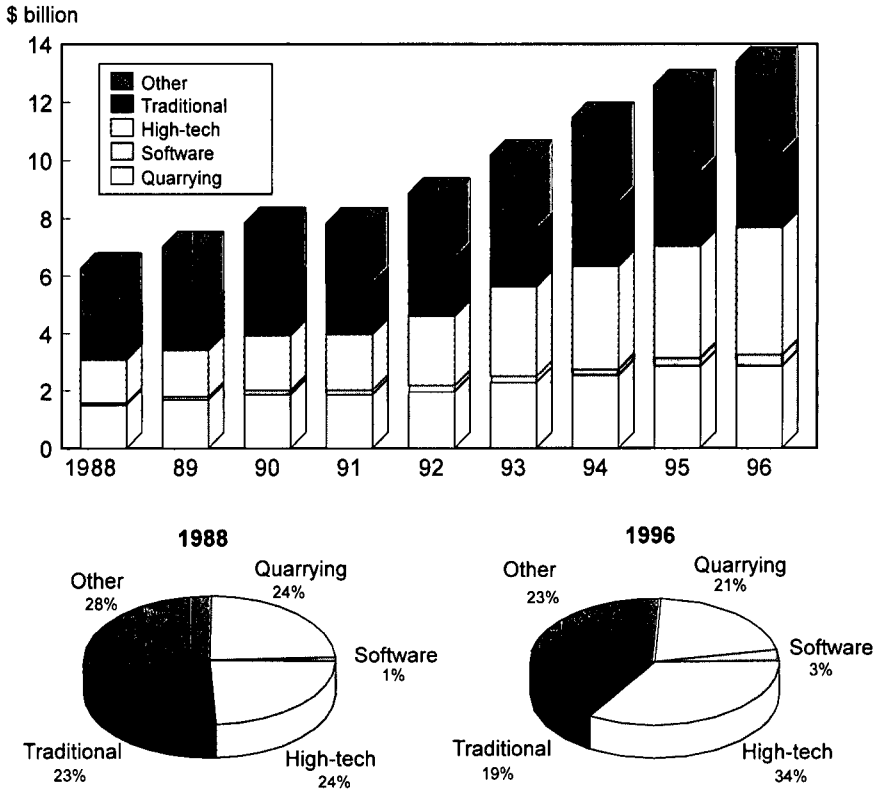
[a] Excluding ships, planes, diamonds, and the Autonomy and the administered areas.

advantages—its human capital. The expansion of this industry was based on extensive foreign investment, both by private investors and through offerings on stock markets abroad. Some firms would have grown even more had it not been for the serious shortage of certain skilled workers, especially engineers and technicians.

Exports of mining and quarrying, and of non-metallic minerals, industries which are highly susceptible to world developments,[12] fell by 8.5 and 9.6 percent respectively. Most exports of transport vehicles (much of which consists of defense exports) are of airplanes, which are sold in large but discrete transactions and are hence characterized by wide fluctuations. The decline in world demand for defense equipment has reduced

[12] According to the *World Economic Outlook*, the world (dollar) price of minerals fell sharply in 1996, after rising steeply in 1995.

Figure 6.3
Industrial and Software Exports, 1988-96



the exports of this industry in the last few years, and in 1996 they fell by 3.7 percent, after plummeting by 30 percent in 1995.

There is considerable variance between the export trends of different industries. About one third of all industrial exports are of high-tech industries, which grew by between 15 and 20 percent in 1996. The traditional industries, whose exports declined, account for about 19 percent. Quarries, minerals, and oil refining, whose exports also fell and which are profoundly affected by world developments in these industries, account for some 21 percent. The heterogeneity of exports, which with time has settled into a pattern, makes them more impermeable to exogenous and endogenous shocks (Figure 6.3).

Exports continued to penetrate new markets.

Despite the strengthening of the dollar (relative to the European currencies), the share of merchandise exports from Israel to the US has not risen. The growth of exports to the other traditional markets, especially the countries of the EU, slackened, apparently also because of the weakening of their currencies. This was partly

responsible for the widening of the trade deficit with the EU, which reached $ 9 billion. The penetration of new markets (especially in Asia, excluding Japan) persisted, and their share of exports rose. The liberalization of trade, which has led to a steep increase in imports from those countries in recent years, may have boosted exports by fostering trade relations with them.

Merchandise imports

Civilian merchandise imports were 4.9 percent higher in volume terms in 1996 than in 1995; excluding fuel, diamonds, and imports from the Autonomy and the administered areas, the rise was 7.4 percent (compared with increases of 11.2 and 8.8 percent respectively in 1995). In dollar terms, import prices fell by 0.5 percent in 1996 (although prices of fuel and diamonds rose by 12.6 and 6 percent respectively), compared with an 8 percent increase in 1995 (Tables 6.5 and 6.A.8).

Civilian merchandise imports, excluding fuel, diamonds, and imports from the Autonomy and the administered areas, rose by 7.4 percent.

The increase in imports of both consumer and capital goods persisted. Imports of intermediates slowed appreciably, though when fuel and diamonds are excluded the change was less pronounced. The persistent rapid expansion in imports of consumer goods and the slowdown in those of intermediates are consistent with macroeconomic developments—the continued steep rise in private consumption and moderation of

Table 6.5
Merchandise Imports, 1991–96

(rate of change, percent)

	Volume				Distribution
	Average 1991–93	1994	1995	1996	1996
Total net merchandise imports[a]	12.4	13.3	10.8	6.2	100
Total civilian imports[b]	12.7	13.5	11.2	4.9	97.2
Total civilian imports excl. fuel, etc.[c]	12.2	15.8	8.8	7.4	73.0
Consumer goods	14.9	19.6	11.6	11.8	13.3
of which Durables	12.1	14.6	12.9	9.4	6.4
Intermediates	12.9	9.6	12.7	4.5	69.0
of which Excluding fuel and oil	12.5	11.4	10.3	6.8	45.5
Capital goods	7.9	23.7	3.6	9.9	18.0
of which Plant and equipment	10.2	17.2	11.7	10.6	12.8

[a] According to foreign-trade figures.
[b] According to balance-of-payments figures.
[c] Excluding fuel, diamonds, and imports from the Autonomy and the administered areas.

aggregate supply, together with the diversion towards imports as their relative price fell. There was a substantial increase in imports of goods for current consumption, especially clothing and footwear, which grew by 25 percent. Alongside the decline in domestic production in this industry, this indicates the diversion of demand to imports as a result of the liberalization of trade. Imports of durables rose more moderately (9.4 percent), with a decline in imports of transport vehicles, following their steep rise in 1995. The slowdown in imports of durables was expected following the sharp increases of the last few years that characterized the period in which new immigrants purchased appliances. Imports of capital goods, especially plant and equipment, rose less steeply than did investment in domestic production of plant and equipment, despite the fall in the relative price of these imports.

The rise in the share of imports from countries with which Israel does not have trade agreements tapered off in 1996. The increase of the last two years derived from the liberalization of trade and extensive imports of durable goods, in which those countries specialize. In 1996 the share of imports from the US and Japan rose steeply—by 20 percent for each country—while imports from new sources grew by only 4 percent. Altogether, the liberalization of trade led to a switch to cheaper sources, and the reduction of tariffs brought consumer prices down.

The services account

Services imports rose by 11.2 percent in nominal terms, mainly because of the steep increase in imports of labor services (foreign workers).

In 1996 the export surplus on the services account (in this section this excludes capital services and the Autonomy and the administered areas) of the last few years turned into a deficit of $ 0.6 billion. Imports of services grew by 11.2 percent in nominal terms, while exports rose by only 2.0 percent (Table 6.A.10). In volume terms, exports of services declined by 0.3 percent, and imports rose by 13.6 percent. The slower rise in income from services exports is largely due to the $ 140 million decline in exports of tourism services, income from which fell by 5 percent, after rising rapidly in the preceding two years (Figure 6.4). As is well known, the sharp swings in this item in the last few years are closely connected with security incidents. The rate of expansion of other services exports slowed markedly, too, most notable being transport services, which are also affected by fluctuations in tourism.

The decline in services exports was due mainly to the fall in tourism.

In terms of volume, services imports surged by 13.6 percent in 1996, while prices, which had risen by 8 percent in 1995, fell by 0.5 percent. The acceleration was not uniform for all components; while imports of tourism and transport vehicles services slowed, those of other services accelerated, especially due to the sharp—56 percent—rise in imports of labor services (foreign workers). The latter was partly offset by a 25 percent drop in imports of labor services from the Autonomy and the administered areas and a 63 percent fall in agents' fees (this item, which consists mainly of commissions, is subject to wide fluctuations).

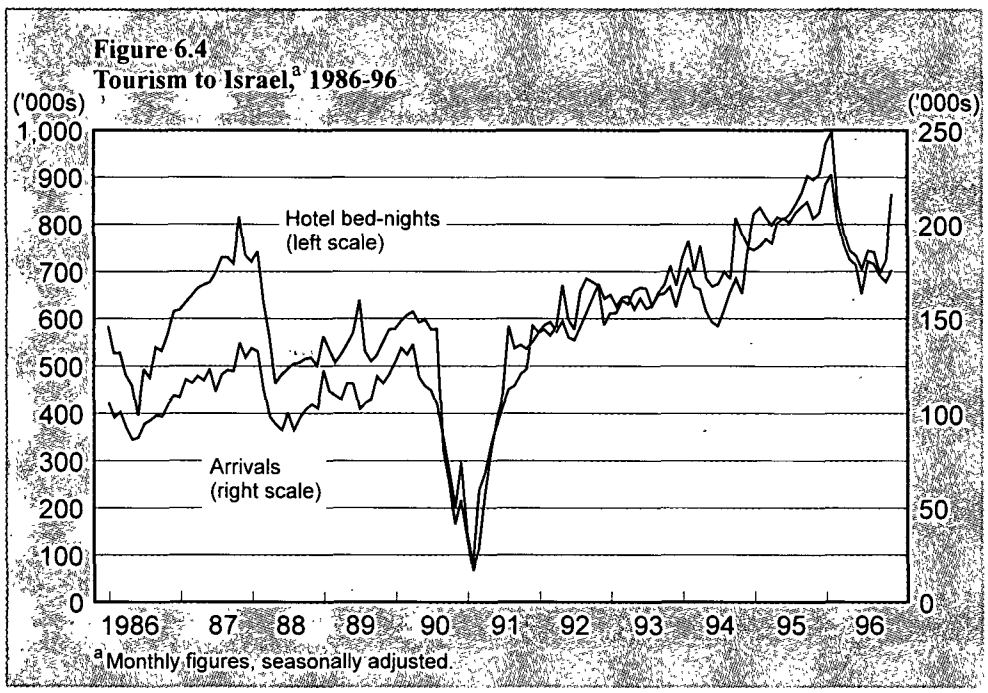


Figure 6.4
Tourism to Israel,[a] 1986-96

Capital services

Net imports of capital services rose by $ 80 million in 1996, to $ 1.5 billionAlthough the extent of capital services is determined mainly by past decisions regarding investments and loans, the expansion of short-term-capital flows and the recent increase in the foreign-exchange reserves accentuate the effect of current decisions, too (Table 6.A.16).

Trade with the Autonomy and the administered areas

There is a growing tendency to replace workers from the Autonomy and the administered areas with foreign workers.

The export of goods and services to the Autonomy and the administered areas remained unchanged, after increasing sharply in 1995. The relatively high level of exports is surprising in view of the steep—33 percent—drop in income from work in Israel. Imports of goods and services from the Autonomy and the administered areas fell by some 10 percent in 1996, imports of goods (especially agricultural) declining by 36 percent after soaring by 62 percent in 1995 (Tables 6.A.3 and 6.A.8). Imports of labor services fell by 25 percent in nominal terms. Trade with the Autonomy and the administered areas has fluctuated widely in the last few years as a result of security incidents and the subsequent closures. Recently, foreign workers have begun to replace workers from the Autonomy and the administered areas, especially in construction and agriculture, making the effect of the closures more long-term in nature. In the

past there has been some substitution between imports of labor services and of goods from the Autonomy and the administered areas, but in 1996 they both declined because for part of the year the closure also applied to merchandise imports.

Unilateral transfers

In 1996 unilateral transfers amounted to $ 7.9 billion ($ 7.3 billion in 1995), and their share of GDP fell slightly (Table 6.A.11). Transfers by the private sector remained stable relative to 1995, after growing in the last few years. This is explained by the rise in transfers by new immigrants and does not appear to be connected with changes in yield differentials in this period. Transfers to the public sector, which amounted to $ 3.6 billion in 1996, were up by 17 percent over 1995.

3. THE CAPITAL ACCOUNT

Main developments

Capital inflows exceeded the current-account deficit financing requirement.

Capital inflow (both long- and short-term) was significantly higher in 1996 than the current-account deficit financing requirement, and was accompanied by a $ 3.5 billion rise in the official foreign-exchange reserves.[13] The extent of the long-term capital inflow was similar to the current-account deficit, so that the basic account was more or less balanced. The capital inflow of the private sector ($ 5.4 billion in 1996), which exceeded its current-account deficit financing needs, contributed to the rise in the foreign reserves,[14] and consequently the implied capital imports of the private sector were over $ 6 billion. In 1996 the public-sector surplus on its current-account balance of payments was $ 500 million, and it contributed $ 2.6 billion to the reserves (Table 6.6).[15]

The rise in long-term-capital flows, especially of nonresidents, is connected with the improvement in Israel's economic standing and credit risk rating.

The deficit on the current account has risen significantly in the last four years, after this showed a surplus or small deficit in the late 1980s. Long-term capital switched from an annual average inflow of less than $ 100 million in 1988–92 to one of $ 2.9 billion in 1993–96, alongside a marked rise in foreign direct investment in 1995 and 1996 (see section on capital flows below). The notable expansion of certain long-term capital flows, especially the share of net foreign investment in financing the deficit, is connected with the improvement in Israel's risk rating in the last few years. This improvement derives *inter alia* from economic and political developments, the

[13] See note 2.

[14] At the end of February 1997 the foreign-exchange reserves were almost $ 14 billion.

[15] This included the US aid—$ 950 million—that should have been received at the end of 1995.

Table 6.6
The Balance of Payments,[a] 1988–96

($ million)

	Average		1996			
	1988–92	1993–96	1995	Total	Private sector	Public sector
Current-account surplus	334	−3,057	−3,874	−4,898	−5,379	481
Long-term capital inflow	−93	2,926	2,276	4,435	2,683	1,753
Basic account	241	−131	−1,598	−463	−2,696	2,234
Short-term capital inflow	347	623	577	2,183	1,380	803
			(1,527)	(−1,233)		(−147)
Capital flows of banking system	−619	−23	1,063	−460	−198	−262
Errors and omissions	−148	1,088	1,158	2,224	2,370	−146
Rise (−) in official reserves	179	−1,558	−1,201	−3,485	−856	−2,628
			(−2,151)	(−2,535)		(−1,678)
Implied capital imports	−513	4,615	5,075	8,383	6,235	2,147
			(6,025)	(7,433)		(1,197)

[a] Figures in parentheses refer to US aid payments which should have been received in 1995, and are treated as such.

liberalization of capital flows and foreign trade, and the receipt of the US government loan guarantees, which served to ameliorate assessments of the viability of extending credit to Israeli firms and of investing in Israel. In the last few years this process has been in line with the global trend towards investing in emerging economies.

The increase in short-term-capital flows was due largely to yield differentials between domestic and foreign assets.

The main factor serving to increase short-term-capital flows in the last two years was the expected positive yield differential between foreign and domestic assets resulting from the policy mix and specifically from monetary restraint, which kept domestic interest rates relatively high. In the context of excess supply, the cessation of the Bank of Israel's intervention in the foreign-exchange market at the beginning of 1996, enabling the free play of market forces, caused the exchange rate to fall and to fluctuate more widely within the exchange-rate band. This apparently inceased uncertainty regarding the expected exchange rate, thereby causing some slowing of implied short-term-capital imports by the private sector relative to 1995.

The extent of the capital inflow (both short- and long-term) made it possible to finance the current-account deficit alongside a continuous rise in the foreign-exchange reserves, thereby reducing the motivation to take immediate steps to deal with the growing deficit. Since short-term-capital flows are sensitive to yield differentials, this trend could reverse if the latter were to change significantly in favor of foreign assets, creating a dangerous dynamic in the foreign-exchange market. Hence, the ability of these flows to constitute a stable source of financing for the current-account

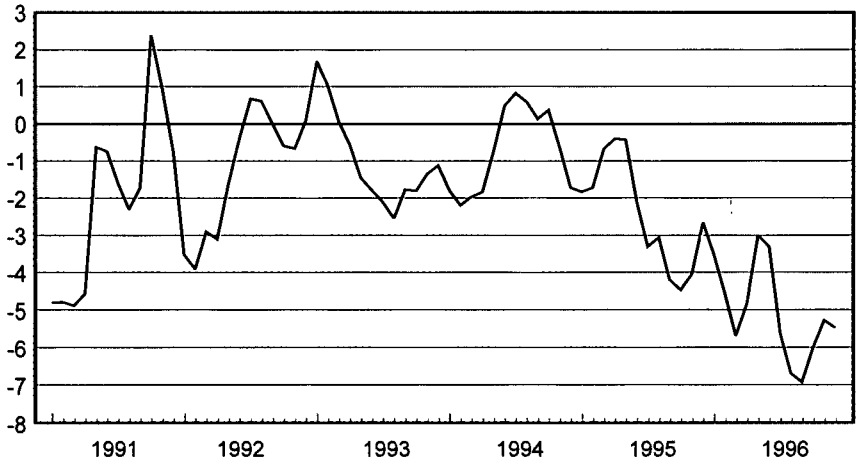
deficit is limited. Although the inflow of long-term-capital is less responsive to short-term changes in interest-rate differentials, and the risk inherent in them with regard to large and rapid changes in the Bank of Israel's foreign-exchange reserves is smaller, there is no guarantee that the long-term-capital inflow of the last few years will persist at that level. Shifts in foreign assessments regarding Israel's economy, as well as exogenous changes such as a slowdown in the worldwide trend of investing in emerging economies, could impair the ability to finance the deficit by long-term-capital inflow. On the other hand, the persistence and even acceleration of the trend of long-term-capital inflow, without an equivalent increase in domestic demand, will help to perpetuate the real appreciation of the last few years, as has occurred in several countries.

Monetary policy, the exchange rate, and the foreign-exchange reserves

The exchange rate against the currency basket rose by 3 percent during the year.

The official foreign-exchange reserves rose by $ 3.5 billion in 1996, the private sector contributing $ 860 million to the increase, and the public sector $ 2.6 billion.The exchange rate against the basket of currencies rose by about 3 percent during the year, less than the slope of the exchange-rate band (6 percent), with a trend away from the midpoint rate (Figure 6.5). The exchange rate against the dollar rose by 5 percent during the year—the difference in the change in the two exchange rates being due to the strengthening of the dollar relative to the other currencies comprising the basket.

Figure 6.5
Departure from the Midpoint Rate of the Exchange Rate Against the Currency Basket, 1991-96



SOURCE: Bank of Israel.

During most of 1996 there was excess supply on the foreign-exchange market, due in part to the interest-rate differentials arising from the Bank of Israel's contractionary monetary policy, and in part to continued long-term-capital inflow. In 1995, in order to prevent the exchange rate from falling too far within the exchange-rate band, the central bank bought foreign exchange. Since February 1996, however, it has refrained from intervening in the market provided the exchange rate is above the lower limit of the band, allowing excess supply to depress the exchange rate without affecting the reserves. In mid-1995 the exchange-rate band was widened from ±5 percent to ±7 percent, allowing the exchange rate to respond more fully to shifts in supply (Figure 6.6).

For most of the year the Bank of Israel allowed excess supply to depress the exchange rate.

The increasing openness of the economy to capital movements makes it difficult to conduct monetary policy given an exchange rate that fluctuates within a band. If domestic interest rates create yield differentials vis-à-vis abroad, this will be expressed

Figure 6.6
The NIS Exchange Rate Against the Currency Basket and the Dollar, 1992-96

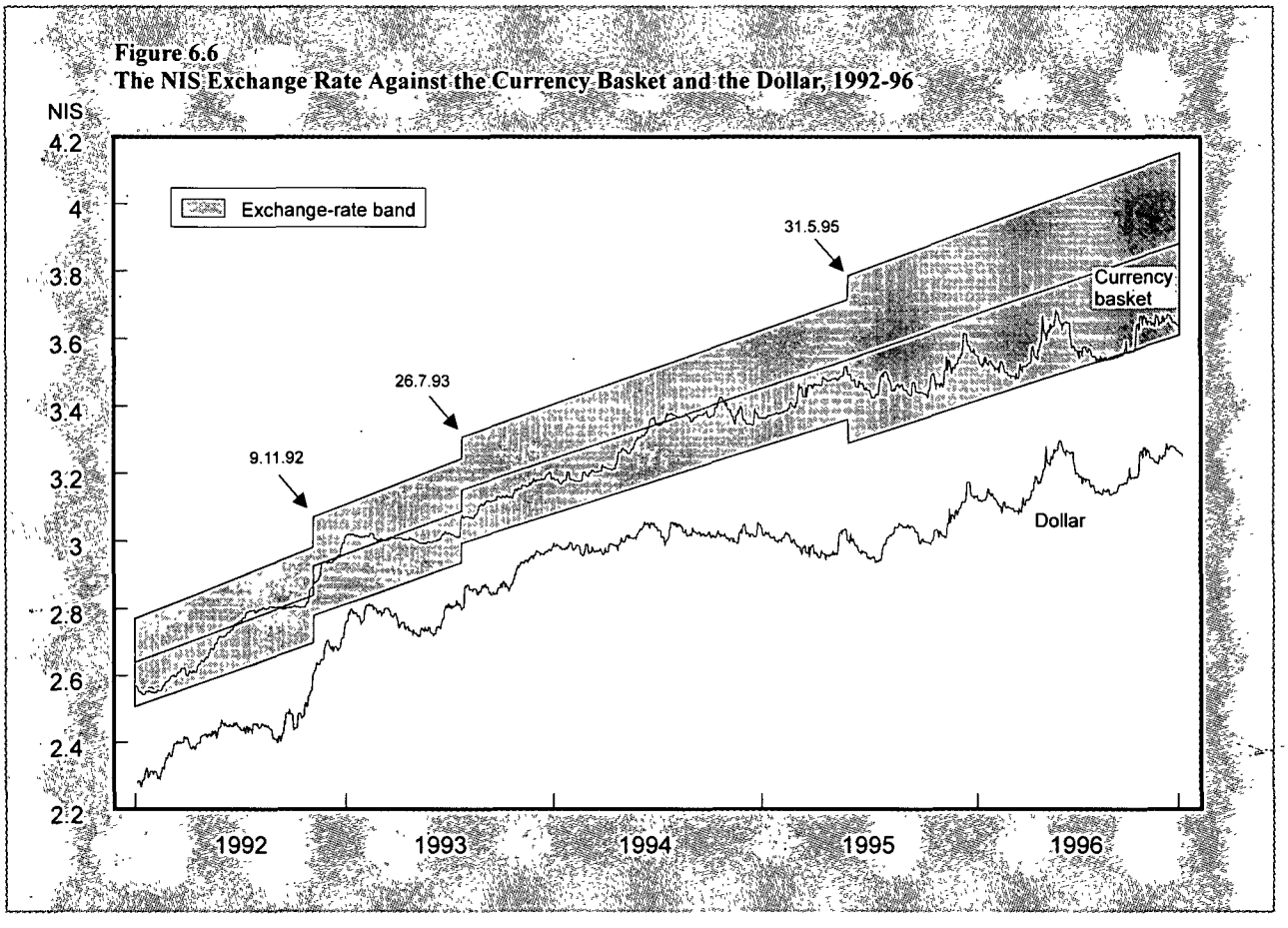
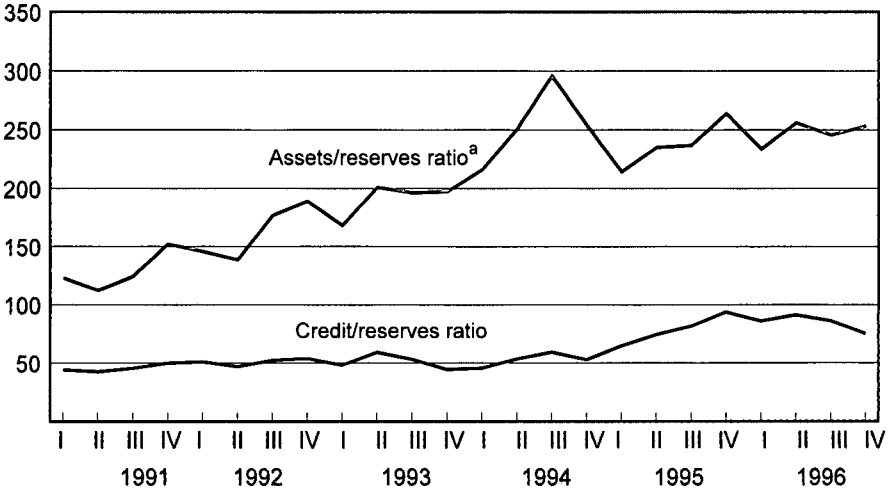


Figure 6.7
Ratio of Short-Term Foreign-Currency Credit and Assets to the Official Reserves, 1991-96



[a] Assets assessed according to dollar exchange rate at upper limit of exchange-rate band.
SOURCE: Based on Central Bureau of Statistics data.

to a great extent by excess supply of foreign exchange, and hence also by nominal appreciation, provided the central bank does not intervene. If it does intervene in the foreign-exchange market, however, the central bank must also do so in the money market, in order to absorb excess liquidity—and must bear the attendant costs.

The Bank of Israel's foreign-exchange reserves indicate the economy's ability to meet its short-term commitments. One of the measures of this is the number of import months covered by the reserves. The substantial increase in the foreign-exchange reserves in the last two years was not reflected by a significant rise in the number of import months, due to the marked expansion of imports (Table 6.A.18). However, the importance of the official foreign-exchange reserves is declining as the economy becomes more open to capital flows. This change makes it possible to finance the current-account deficit (in the short term) to a greater extent by capital inflow, relying less on the reserves. However, the relative ease with which capital may flow also makes a rapid drop in the reserves possible if economic agents' assessments change. Indicators of potential pressure on the reserves are the ratios of liquid local-currency assets and of short-term foreign-currency credit to the reserves (Figure 6.7). These two ratios rose significantly in the last two years despite the marked increase in the reserves, indicating that demand pressures could emerge on the foreign-exchange market if there were a shift in assessments regarding changes in the exchange rate.

Capital flows

The public sector

The public sector financed the domestic deficit primarily by borrowing abroad.

The public sector increased its borrowing abroad, taking loans of a net $ 1.8 billion in 1996 to finance its activities. The backdrop to this was the increased budget deficit financing requirement, which substantially exceeded the 1996 target, and the absence of an increase in net domestic financing through the issue of bonds and sale of assets. Gross borrowing by the government in 1996 by means of bonds issued under the US government guarantees was $ 1.9 billion, most of which served to finance the domestic deficit after the US had permitted this.[16] In contrast with 1994 and 1995, when the government extended credit amounting to $ 1.5 billion borrowed in this framework to the private sector, in 1996 it transferred less than $ 100 million to this sector In addition, net borrowing abroad by the government amounted to $ 400 million through issues of independence and development bonds, and an unprecedented $ 470 million not under the US government guarantees on European and US markets,[17] $ 200 million of which was borrowed for the first time by means of Eurobonds. Interest on loans under the US government guarantees was 0.1 to 0.2 percentage points higher than the yield on US government bonds, so that together with the various commissions and expenses this differential was 0.7 percentage points. The fact that the government also resorted to markets abroad to finance the domestic budget deficit reduced the pressure on domestic yields, which on average were slightly higher in 1996 than in 1995 and above financing costs abroad. The US government guarantees enable Israel's government to obtain credit on relatively good terms, as a result of both their direct effect on the cost of credit extended under them and their indirect effect on the country's risk rating. Net borrowing by the government not under the guarantees at this relatively early stage improves its ability to borrow on international markets in the future, even when the guarantees are no longer in effect, because of the experience and repute acquired. Nonetheless, financing the budget deficit by borrowing abroad, which increases the money supply (rather than financing it by net borrowing from the public) requires the deployment of monetary instruments in order to absorb the excess liquidity. This procedure incurs costs which eventually increase the public-sector deficit. Consequently, the overall cost of financing the domestic budget deficit through the

[16] At the beginning of 1997 the government borrowed an additional $ 750 million under the guarantees. Altogether, to date the government has borrowed $ 7.3 billion in this framework, and is entitled to borrow another $ 2 billion in 1997 and 1998.

[17] Some $ 210 million was from banks in Europe and the Far East, $ 200 million in Eurobonds, and $ 58 million (denominated in German marks) as an additional tranche within the framework of $ 250 million (in German marks), part of which was borrowed in 1995 from banks in Europe, the US, and the Far East.

foreign debt is higher than is indicated by foreign-debt-servicing costs. Furthermore, reducing the government's net domestic borrowing alongside absorption by the Bank of Israel serves to increase the liquidity of the domestic public-sector debt.

The recorded short-term capital inflow of the public sector was $ 800 million in 1996. This represents the recorded capital inflow of $ 950 million arising from the need to adjust balance-of-payments items to the delay in the receipt of part of the US aid and the smaller capital outflow. Without this adjustment the extent of recorded capital exports by the public sector in 1996 is smaller, similar to the amount of recent years.

The nonfinancial private sector

Reported capital inflow of the nonfinancial private sector was $ 4 billion.

The reported capital inflow of the nonfinancial private sector was $ 4 billion in 1996—$ 2.7 billion of it long term, and the rest short term. Implied capital imports of the nonfinancial private sector (this sector's current-account deficit *plus* its effect on the reserves), which includes the foreign-currency credit taken by this sector from domestic banks (i.e., from authorized dealers) and converted into local currency, was lower than in 1995, but still very high—some $ 7.6 billion.The decline in 1996 reflects mainly the slower rate of expansion of credit from authorized dealers.

Much of the inflow of long- and medium-term capital of the nonfinancial private sector came from nonresidents' investment in Israel.

Long- and medium-term capital flows: The long- and medium-term capital inflow of the nonfinancial private sector rose to $ 2.7 billion in 1996 from $ 1.5 billion in 1995—over 60 percent being net investment in Israel by nonresidents, and the rest long- and medium-term loans (Table 6.8). Capital inflow fluctuated widely during the year because of the way capital was raised—relatively large share offerings, and borrowings at certain times during the year.

Table 6.7
Implied Capital Imports of the Private Sector, 1992–96

($ billion)

	1992	1993	1994	1995	1996
Total capital inflow of private sector	−2.4	1.0	1.4	6.4	6.2
Short-term	−1.3	0.8	0.6	4.9	3.6
Total foreign-currency sources of nonfinancial private sector[a]	−1.4	0.0	3.0	10.9	7.6
Short-term	−0.2	−0.1	2.2	9.4	4.9

[a] Including foreign-currency credit from domestic banks.

Table 6.8
Long- and Medium-Term Capital Flows of the Nonfinancial Private Sector, 1994–96

($ million)

	1994	1995	1996
Foreign direct investment	415	1,516	1,984
Foreign portfolio investment (TASE)	183	386	340
Foreign investment[a]	626	1,912	2,355
Residents' direct investment abroad	735	671	762
Residents' portfolio investment abroad	−303	3	−79
Residents' total investment abroad	433	673	682
Net investment	192	1,237	1,672
Loan receipts	1,153	945	1,655
Loan repayments	600	656	645
Net loans	553	288	1,010
Total long- and medium-term capital flows	745	1,525	2,682

[a] Also includes loan and development bonds, investment in merchandise, and reinvestment of profits.

Net long-term borrowing abroad by the nonfinancial private sector was about $ 1billion in 1996, prominent among this being the $ 700 million borrowed by the Israel Electric Company[18]—$ 125 million of it for 30 years and $ 125 million for 100 years—and the $ 350 million borrowed by Bezeq (the telephone company). The readiness of nonresident investors to extend long-term credit to an Israeli company attests to the trust they place in Israel's ability to meet its long-term obligations. The premium required by lenders on the loan extended to the Electric Company was 0.9 percentage points above the yield on US T-bonds for the same period, also indicating that the risk attributed to loans to Israeli firms is not high.

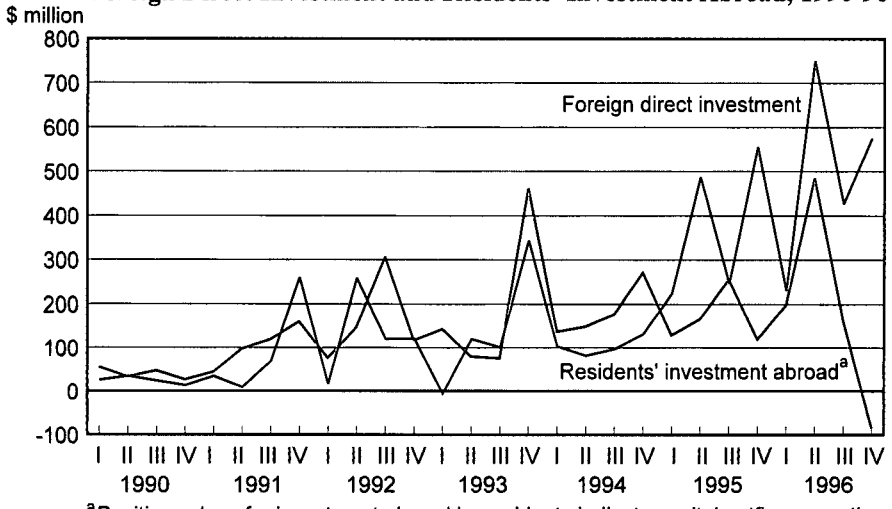
Foreign investment in Israel in 1995–96 was significantly higher than in previous years.

The extent of foreign investment in Israel in 1995–96 was significantly greater than in the past few years, and amounted to $ 2.4 billion, most of it direct and the rest in securities traded on the Tel Aviv Stock Exchange (TASE)[19] (Figures 6.8 and 6.9). The increase in 1996 was due entirely to the $ 400 million raised in share oferings

[18] Like the other public-sector corporations, the Israel Electric Company is ascribed to the private sector in the balance of payments.

[19] Nonresidents' purchases of Israeli securities offered abroad is recorded by the CBS as direct investment; purchases of securities on the TASE is recorded as investment in securities. This classification, which makes no economic distinction between investments that are essentially long-term and others that are of a short-term and/or financial nature, will be changed in the future.

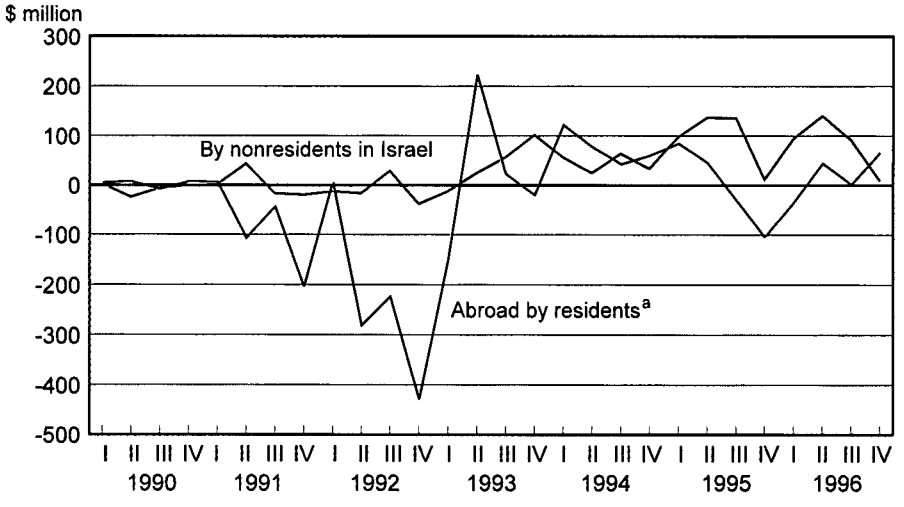
Figure 6.8
Foreign Direct Investment and Residents' Investment Abroad, 1990-96



[a]Positive values for investment abroad by residents indicate capital outflow, negative values indicate capital inflow (sales of assets).

SOURCE: Based on Central Bureau of Statistics data.

Figure 6.9
Net Portfolio Investment Abroad, 1990-96



[a]Negative values indicate capital outflow.

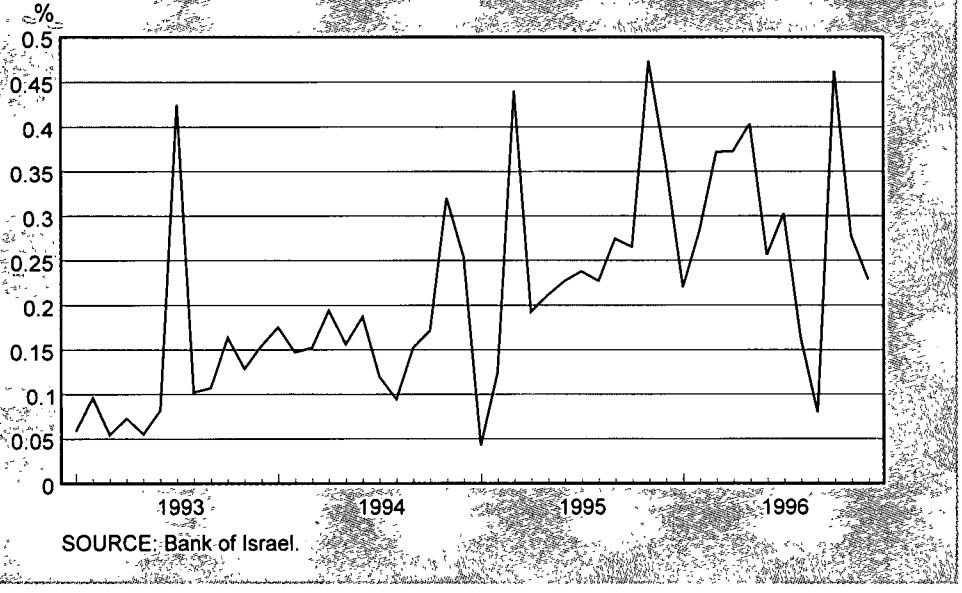
SOURCE: Based on Central Bureau of Statistics data.

abroad by Israeli firms (both public and private), which accounted for about one third of total direct investment in 1996, especially in software, communications, and chemicals. In the last few years there has been a tendency for industrial firms, especially in computers and electronics, to raise capital by offering shares on the US capital market[20] rather than in Israel. This increases the share in these firms held by nonresident investors, and signals the latter's trust in the firms' ability to grow. Since 1992 investment in Israel by nonresidents has been rising gradually. To a great extent, this trend is in line with the significant improvement of the last few years in Israel's credit risk rating, and was accompanied by an equivalent rise in nonresidents' investment in Israeli securities.

Economic activity in Israel by nonresidents is explained by long-term considerations rather than short-term yield differentials.

Foreign investment in securities traded on the TASE amounted to $ 340 million in 1996. This kind of investment, which tends to fluctuate quite widely, has risen considerably since mid-1993 as a result of positive political developments at that time. The stock of government bonds and Treasury bills held by nonresidents remained at the low level of 1996—$ 220 million—most of it in foreign-currency-indexed bonds. It seems, therefore, that considerations concerning Israel's economic future played a large part in nonresidents' decisions regarding investment in Israel in 1996, and are relatively less sensitive to short-term changes in expected yields on alternative assets.

Figure 6.10
Monthly Standard Deviation of Currency-Basket Exchange Rate, 1993-96



SOURCE: Bank of Israel.

[20] In 1996, 75 percent of offerings (including private placements) were made abroad (40 percent in 1995).

Table 6.9
Indicators of the Yield Differential, 1995–96

(percent)

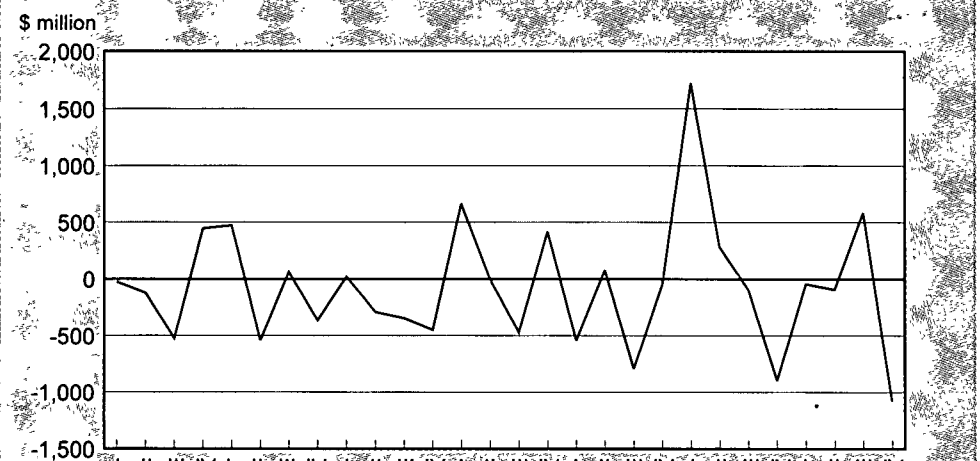
	1995				1996			
	I	II	III	IV	I	II	III	IV
Interest on								
3-month local-currency credit	18.7	16.8	16.2	16.7	16.6	17.4	18.4	17.8
3-month foreign-currency credit[a]	7.0	7.0	6.7	6.5	6.0	6.0	5.9	6.0
Yield to maturity on 3-month Treasury bills	16.0	13.8	13.5	14.1	14.2	16.0	16.3	15.3
Libor	5.8	5.5	5.3	5.2	4.7	4.7	4.8	4.7
Expected depreciation based on								
Slope of band	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Slope *plus* distance from midpoint rate	7.4	7.0	9.5	9.7	10.5	9.6	12.4	11.6
Actual depreciation	10.7	3.5	−2.5	13.4	−6.5	17.7	−8.4	13.0
Yield differential on assets[b]								
Slope of band	6.2	4.2	4.0	4.7	5.1	7.0	7.2	6.3
Slope *plus* distance from midpoint rate	4.8	3.2	0.6	1.0	0.7	3.3	0.8	0.6
Perfect projection	1.5	6.7	12.6	−2.7	17.6	−4.8	21.6	−0.7
Yield differential on liabilities								
Slope of band	5.7	3.8	3.5	4.2	4.6	5.4	6.5	5.9
Slope *plus* distance from midpoint rate	4.3	2.8	0.0	0.5	0.0	1.7	0.1	0.3
Perfect projection	0.9	6.3	12.0	−3.2	17.1	−6.4	21.0	−1.1
Standard deviation of NIS/currency-basket exchange rate	0.03	0.01	0.02	0.05	0.02	0.05	0.01	0.04

[a] In currency-basket terms.
[b] *Less* 35 percent income tax on foreign-currency interest.

The reason for this may lie in considerations of exchange-rate risk, which nonresidents perceive as relatively large, so that the yield differentials facing them are not attractive. Shares and convertible securities held by nonresidents constitute 10 percent of the total market value, while tradable bonds account for less than 1 percent.

Net investment abroad by residents was $ 700 million in 1996, similar to its level in the last few years. About half of it was in chemicals and oil, reflecting mainly one large transaction. Most of the investment of recent years has been in electronics and communications, principally in western Europe and the US. The extent of investment in the traditional industries—textiles and food, which require less skilled workers—and in eastern Europe, where labor costs are relatively low, is small, so that investment abroad does not appear to stem from considerations of labor costs, but rather from those of cooperation, in the context of technological and marketing needs.

Figure 6.11
Capital Flows[a] of the Banking System, 1990-96



[a] Positive values indicate capital inflow, and negative values indicate capital outflow.
SOURCE: Based on Central Bureau of Statistics data.

Short-term flows: Recorded short-term capital inflow of the nonfinancial private sector in 1996 was $ 1.4 billion. Assuming that the 'errors and omissions' item in the balance of payments mainly reflects unreported short-term capital flows,[21] the short-term capital inflow of the nonfinancial private sector[22] may be estimated by calculating the difference between this sector's basic account and its contribution to the foreign-exchange reserves. The short-term capital flows of the entire private sector (including the financial sector) may be estimated in the same way. This calculation shows that while short-term capital inflow moderated to some extent in 1996, it is still quite substantial (Table 6.7). In the long run, the rise in implied short-term capital imports is notable, and is presumably due to the rise in nominal local-currency interest in this period and the greater openness of the economy to capital flows.

Short-term capital inflow moderated to some extent in 1996, but was still considerable.

The expected yield differential between domestic and foreign assets (credit) is the interest-rate spread (including the risk premium) together with expectations of an exchange-rate change in the relevant horizon. Domestic interest rates remained relatively high in 1996—the annual average interest on 3-month local-currency credit was 17.5 percent, similar to the rate in 1995.[23] On the other hand, indicators of interest

Yield differentials between domestic and foreign assets have remained relatively stable in the last two years.

[21] Part of this item may also reflect measurement problems in other current-account items, especially tourism, diamonds, and other services.

[22] This estimate includes the foreign-currency sources that the domestic banks make available to the nonfinancial private sector.

[23] Interest on longer-term unindexed credit was one percentage point higher, so that the spread on foreign-currency credit was even greater.

rates abroad show that they fell slightly, helping to widen the spread. Since depreciation expectations are not an observable variable, they can be estimated by making various assumptions. Accordingly, as Table 6.9 shows, yield differentials in the last two years were relatively stable on average, with a slight rise in 1996.

Decisions regarding the asset (and liabilities) portfolio should also relate to the level of uncertainty involved in assessing the expected yield. The cessation of the Bank of Israel's intervention in foreign-currency trading serves to increase expected exchange-rate variance (even though this may not actually happen), and consequently increases the risk associated with foreign-currency assets (credit), and may cause short-term capital inflow to decline. The greater volatility of the exchange rate in 1996 than in 1995 (Figure 6.11) supports the hypothesis that the risk arising from exposure to foreign-currency liabilities has increased. A marked rise in the demand for instruments intended to hedge against exchange-rate changes a marked rise in 1996 supports this assessment. The fact that the exchange rate remained close to the lower limit of the band in September and October, alongside the Bank of Israel's intervention to prevent it from deviating from the band, did not serve to significantly increase expectations that it would rise. The explanation for this may lie in the expectations of the public that the interest rate would remain relatively high, in view of the deviation from the planned budget deficit and efforts to attain the inflation target.

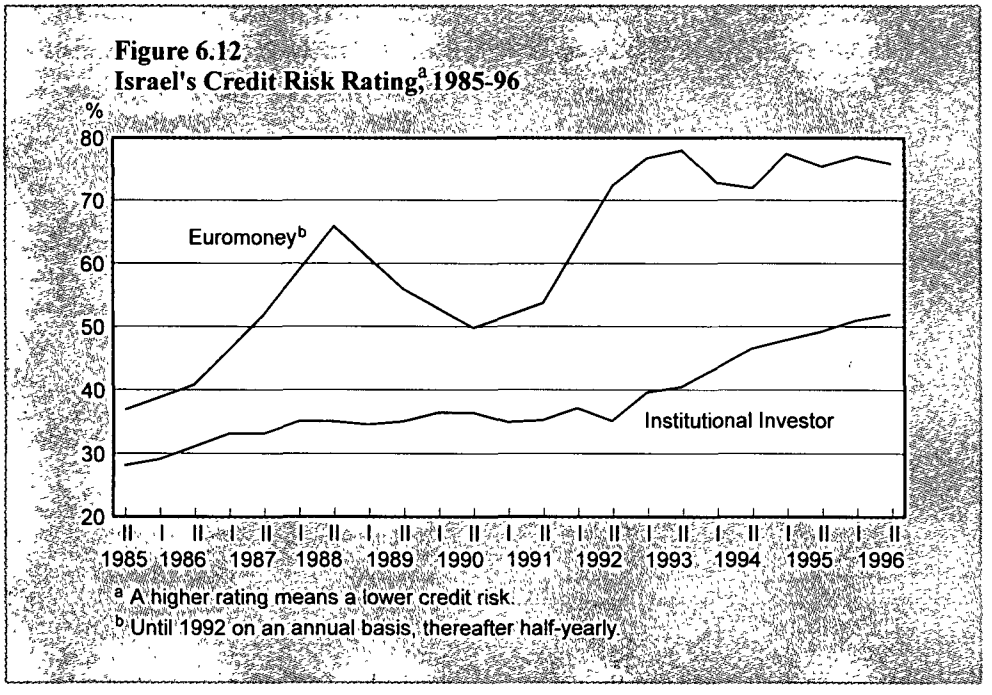
Country risk: A country's or firm's risk rating is an important tool for enabling potential investors and lenders to assess the level of risk involved in a given transaction, and consequently influences readiness to extend credit as well as its cost. Israel's past economic performance, which attests to the nature and functioning of the markets, and assessments of its future performance—growth potential and risk—are crucial elements in its rating. The size of the current-account deficit, and of the debt which is derived from it, are very important in assessing a country's ability to meet its obligations, and hence the risk associated with lending to it.

At the end of 1996 Standard & Poor's agency again gave Israel the relatively high rating of A–.

Israel's credit risk rating,[24] as reflected in the lists published by the journals *Euromoney* and *Institutional Investor*, indicates a significant improvement in 1993 relative to the 1980s, in the wake of political developments, and this has remained relatively stable since then (Figure 6.12). An important rating, published by *Standard and Poor's*, accorded Israel a relatively high rank, A– in 1996, similar to its 1995 rating. The rating accorded by *Moody's* was similar. Another positive indicator was the decision by the IMF at the beginning of 1997 to include Israel in the category of industrialized economies.

[24] A higher rating means lower risk.

Figure 6.12
Israel's Credit Risk Rating[a], 1985-96



[a] A higher rating means a lower credit risk.
[b] Until 1992 on an annual basis, thereafter half-yearly.

The liberalization of capital flows: The main advantage of liberalizing capital flows is its contribution to improving the competitiveness of the financial sector and encouraging foreign investment in Israel, while presenting savers and investors with true prices and improving the efficiency of resource-allocation. Liberalization increases capital flows to and from Israel, and hence accentuates fluctuations in the exchange rate and/or the foreign-exchange reserves. On the other hand, it also helps to expand the foreign-exchange market and thus also works in the opposite direction—reducing fluctuations.

The liberalization of capital movements in recent years has been characterized by the gradual removal of controls, facilitating financial transactions between Israel and abroad.[25] No substantial changes were made in the Foreign Exchange Control regulations in 1996, the principal amendments being that residents were permitted to purchase vacation units abroad for up to $ 15,000, subject to certain restrictions, the ceiling on credit card purchases in foreign currency was raised, and import payments could be made by means of computerized communication. Some additional relaxations of the regulations were introduced in January 1997 regarding the management of foreign-exchange accounts, purchase of foreign securities and foreign currency, and export of assets. Despite the liberalization measures, there is still asymmetry between

The liberalization of capital flows in recent years has been characterized by the gradual removal of controls, making financial transactions between Israel and abroad easier.

[25] See also previous editions of this publication and reports of the Controller of Foreign Exchange.

Despite the liberalization process, there is still asymmetry between the controls and taxation on capital inflow and outflow.

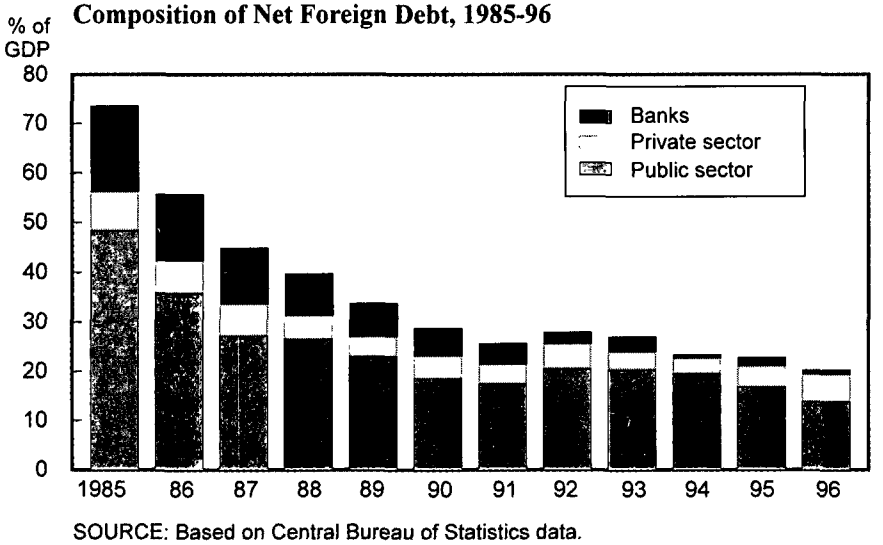
the restrictions and taxation on capital inflow and capital outflow. Over and beyond long-term considerations that support greater liberalization, including that of capital outflow, the reduction of discrimination would make portfolio investment abroad more attractive[26] (especially in view of the surge in the financial markets abroad), reduce the supply of foreign currency, and make monetary-policy management easier. In addition, the tax distorts the allocation of resources, preventing the country from attaining the larger income that could be obtained by investing abroad. Nonetheless, caution is required in the removal of restrictions in order to minimize the danger that capital inflows will reverse and become extensive capital outflows which could shake the financial markets.

4. THE FOREIGN DEBT AND THE RESERVES

The net foreign debt continued to decline as a percentage of GDP in 1996.

The current-account deficit can be financed by drawing down the official foreign-exchange reserves, borrowing abroad, or net investment by nonresidents. In 1995–96 the latter financed 30 percent of the deficit, compared with some 7 percent in the preceding two years. The equivalent decline in financing by borrowing abroad was expressed in a relatively slow rise in net liabilities, despite the increase in the current-account deficit.

Figure 6.13
Composition of Net Foreign Debt, 1985-96



SOURCE: Based on Central Bureau of Statistics data.

[26] The Dow-Jones Index in New York went up by some 26 percent in 1996; after deducting 35 percent for taxes, the real dollar yield was about 17 percent.

In 1996 the declining trend in the net foreign debt/GDP ratio—which has been evident since the mid-1980s—continued; from a peak of 74 percent in 1985 it fell to 20.5 percent at the end of 1996[27] (Figure 6.13). At the beginning of the 1990s the reduction of the debt was made possible primarily by the decline in the debt of the private sector (including the financial sector), while the government's debt remained stable (Table 6.10). The significant rise in the current-account deficit of the private sector since 1995 has served to increase the foreign debt of that sector (including the financial sector). Furthermore, capital inflow over and beyond the deficit-financing requirement of the private sector, with the resultant rise in the Bank of Israel's foreign-exchange reserves, contributed to the rise in the debt of the private sector and an equivalent fall in that of the public sector. The fact that part of the government's domestic deficit was financed by borrowing abroad (alongside a surplus in the government's foreign current account) did not affect its foreign debt because it was accompanied by a proportionate increase in the foreign-exchange reserves. All in all, the rise in the foreign-exchange reserves contributed 2.4 percent of GDP to the reduction of the net foreign debt of the public sector.[28]

The recorded decline in the debt burden is biased downward because the faster rise in the implicit price index of GDP than in the nominal exchange rate against the dollar overstates the value of GDP in dollar terms. Net debt-servicing payments fell by 7 percent in dollar terms in 1996 due to the decline in repayment of the principal and stability in net interest repayments. This development was expressed in a decline in the debt-servicing burden relative to both GDP and exports (Table 6.A.16).

Table 6.10
Sectoral Composition of Net Foreign Debt, 1991–96

(percent of GDP)

	1991	1992	1993	1994	1995	1996
Nonfinancial private sector	4.3	5.3	3.9	3.4	4.5	5.8
Banking system	4.4	2.6	3.2	0.9	1.9	1.1
Public sector	17.3	20.3	20.1	19.4	16.5	13.6
Total	26.0	28.3	27.3	23.8	22.9	20.5

[27] Note that the reported debt, especially the short-term one, is an underestimate.

[28] This figure includes $ 950 million ofUS aid for 1995, see note 2.