Chapter 7
The Balance of Payments

- The current account was in a surplus equal to 4.9 percent of GDP in 2006 which is an exceptionally high level, both from the historical and international perspectives.
- The high current account surplus was primarily the result of the tax reform on investment abroad and the expansion of investment by institutional investors abroad, larger-than-expected public savings and a domestic interest rate at a similar level to that in the US, which created pressure for both a nominal and a real depreciation.
- In addition to these forces, there are others acting to reduce investment and increase the share of savings in GDP, which would mean a rise in the current account surplus. These forces include the decline in the number of immigrants arriving in Israel, which exerts downward pressure on investments; the structural change in the economy, that serves to reduce the physical investment and to increase the investment in human capital—which theoretically are likely to offset each other, but in the light of individuals' liquidity constraint and their uncertainty regarding the return to education, the reduction in physical investment is the stronger effect; and the shrinking of the social security net, which raises the level of individual's uncertainty about their future situation and tends to increase private savings.
- The rapid growth in the last three years, accompanied by an increase in the current account surplus, in contrast to the previous period of growth in which the deficit in the current account expanded, emphasizes the intensity of the forces acting to create the surplus. These include exports, which are a leading factor in the growth process, and short-term factors that support real depreciation. Together these factors have led to a current account surplus alongside rapid growth.
- In 2006, the upward trend in the net export of investment continued, alongside an increase to record levels of investment flows into and out of the economy. This trend, which began in 2002, is a manifestation of Israel's integration within the global economy and is a result of both global and domestic factors.
- The global processes that have influenced the financial account this year are primarily cyclical and include the continuing global trend of mergers and acquisitions, which has worked to increase the volume of direct investment by nonresidents in Israel. The sharp decline in share indices in the emerging markets in May-June worked to reduce the volume of financial investment by both nonresidents in Israel and local residents abroad. The domestic influences that brought about the increase in capital flows are primarily structural and are the result of reforms in the financial markets.
- A long-term comparison to countries similar to Israel shows that Israel, like other developing countries, is a net importer of direct investment, though on a relatively small scale. In recent years, there has been a noticeable upward trend in the volume of incoming and outgoing investment in terms of percentage of GDP.
- The proportion of direct investment that contributes directly to capital accumulation within total direct investment has risen since the beginning of the decade but has fallen during the last two years as a result of the privatization process.

1. MAIN DEVELOPMENTS

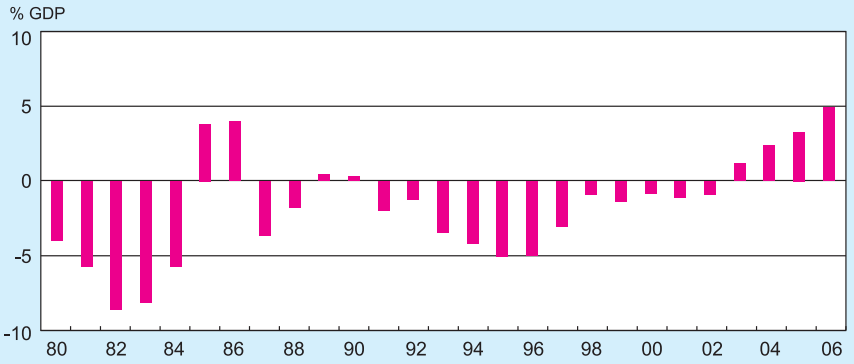
In 2006 the current account posted a surplus of $6.8 billion, 4.9 percent of GDP, exceptionally high by both historical and international standards.

The current account surplus in 2006 totaled $6.8 billion or 4.9 percent of GDP. This is an exceptionally high level both from the historic and international perspectives (see Table 7.1). The increase in the current account surplus this year was mainly the result of an improvement in the services account, an increase in current transfers, and a small decrease in the goods account deficit. A somewhat longer-term view also shows an improvement in all the components of the current account (apart from current transfers). Thus, this was the third year in a row in which the goods and services account was in surplus, in contrast to an average deficit equal to more than 6 percent of GDP during the 1990s. The income account deficit this year was only 1 percent of GDP as compared to 3.3 percent during the 1990s.

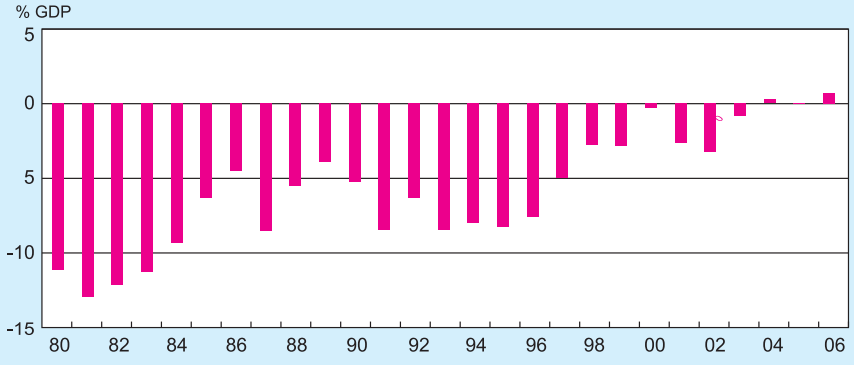
The large surplus in the current account this year was the result of a combination of short- and long-term factors that have acted to increase it (see the discussion in Section 2 below). For more than 10 years, the deficit in the current account has been diminishing and at some point became a surplus. This year, as well, the surplus increased significantly by a rate of more than 1.5 percent of GDP. The rapid growth

Figure 7.1

a. Current Account as Share of GDP, 1980-2006



b. Goods and Services Account as Share of GDP, 1980-2006



SOURCE: Central Bureau of Statistics.

during the last three years accompanied by the growth in the current account surplus, in contrast to previous periods of rapid growth in which the current account deficit increased, is an indication of the intensity of the forces working to create the surplus.

Table 7.1
The Balance of Payments, 1995–2006

($ billion)

	1995-1998	1999-2002	2003	2004	2005	2006
(1) The current account	-3.6	-1.2	1.4	2.9	4.3	6.8
The goods account	-5.8	-4.1	-3.1	-2.8	-3.8	-3.6
Goods exports	21.8	28.1	30.2	36.7	40.1	43.3
Goods imports	-27.6	-32.2	-33.3	-39.5	-43.9	-46.9
The services account	-0.2	1.6	2.1	3.2	3.8	4.5
Services exports	8.6	12.8	13.3	16.0	17.5	19.3
Services imports	-8.9	-11.2	-11.2	-12.8	-13.7	-14.8
The income account	-3.5	-5.2	-4.1	-3.7	-1.7	-1.5
Net investment income[a]	-1.5	-2.4	-1.7	-1.7	0.2	0.4
Residents' income[b]	1.8	2.7	2.6	2.7	5.2	6.2
Nonresidents' income[c]	-3.3	-5.1	-4.4	-4.4	-5.0	-5.7
Compensation of employees	-2.0	-2.9	-2.3	-1.9	-1.9	-1.9
Of which: To foreign workers	-1.6	-2.4	-2.2	-2.0	-1.9	-2.0
To Palestinians	-0.6	-0.7	-0.3	-0.3	-0.3	-0.4
Current transfers	6.0	6.5	6.4	6.3	6.0	7.4
(2) The capital balance	0.7	0.5	0.5	0.7	0.7	0.9
(3) The financial account[d]	2.3	0.5	-2.4	-4.3	-8.7	-7.6
Direct investments, net	0.6	2.0	1.8	-2.5	1.4	0.5
Israelis' investments abroad	-0.9	-1.5	-2.1	-4.5	-3.3	-13.6
Nonresidents' investments in Israel	1.5	3.4	3.9	2.1	4.8	14.1
Portfolio investments	3.1	0.0	-1.3	4.5	-3.7	-0.2
Israelis' investments abroad	0.1	-2.1	-3.2	-2.4	-8.2	-8.8
Nonresidents' investments in Israel	3.0	2.1	1.8	6.9	4.6	8.6
Other investments, net	2.4	-1.2	-1.8	-6.0	-4.6	-7.5
Government	-0.2	-0.1	-0.1	-0.2	1.0	-0.3
Banks	1.1	0.9	-1.8	-4.8	-4.9	-5.4
Other sectors	1.5	-2.0	0.1	-1.0	-0.8	-1.9
Financial derivatives	0.1	0.0	0.0	0.0	0.0	0.0
Change in the foreign exchange reserves[e]	-3.9	-0.3	-1.1	-0.3	-1.9	-0.4
(4) Statistical discrepancies	0.6	0.3	0.5	0.7	3.7	-0.1

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

The high current account surplus reflects a combination of global effects that boosted exports, and domestic effects that acted mainly as a brake on imports.

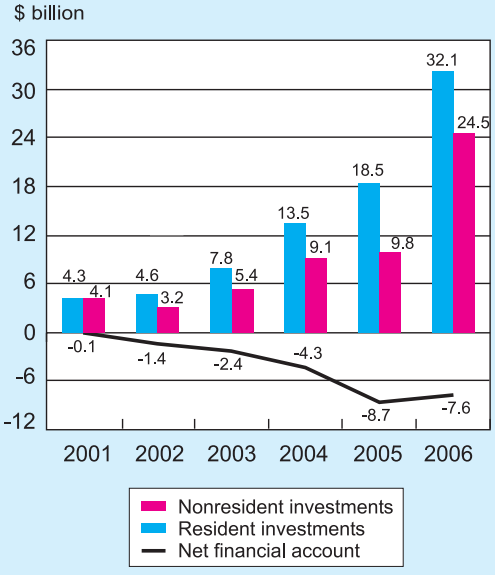
From the point of view of exports, imports and the income account, the large surplus in the current account is a result of a combination of global influences, which support exports and a minimal deficit in the income account, and of domestic influences, which work primarily to slow the growth in imports. The rapid growth in exports is the result of a global development—the rapid growth in world trade—while the low real exchange rate, which reflects domestic influences, has been only a secondary factor in the growth of exports. The improvement in the income account is also the result of a global factor, i.e., the increase in interest rates abroad, which contributes to the increase in income since Israel is a net asset holder in debt instruments. In contrast, the slowdown in imports is primarily due to the real depreciation, an expression of local pressures encouraging the net export of capital and the increase in public saving.[1]

The rapid increase in exports during the last three years has been the leading factor in the growth of GDP. High-tech manufacturing and services led the growth in exports again this year while the exports of more conventional manufacturing and service industries grew more slowly. The export of tourist services, which during the last two years contributed a percentage point to the growth in exports, remained unchanged on average, as a result of the war in Lebanon and its negative effect on the industry.

The financial account totaled a net investment abroad of $7.6 billion, with both investments into and out of the economy reaching record levels.

The balance of the economy's financial account (Table 7.1)—investment by nonresidents in Israel less the investment by Israeli residents abroad (including the government and the foreign exchange reserves of the Bank of Israel)—represents a net investment abroad of $7.6 billion (Figure 7.2) accompanied by an increase to record levels in the investment by nonresidents in Israel and the investment by Israeli residents abroad. This is a continuation of the upward trend that began in 2002 in the size of investment flows in both directions. This trend reflects the integration of

Figure 7.2
Nonresident Investments, Resident External Investments, and Net Financial Account, 2001–2006



SOURCE: Central Bureau of Statistics.

[1] Lavi and Friedman (2006) show that the influence of the real exchange rate on exports is small, apparently because exports are biased towards hi-tech industries in which profit margins are high. In contrast, they find an elasticity of 0.4 of imports with respect to the real exchange rate. Y. Lavi and A. Fridman (2006), "The Real Exchange Rate and Israel's Foreign Trade", Bank of Israel Annual Survey 79. A similar result was found by Y. Soffer (2005), "Measuring the Real Exchange Rate and its Influence on Exports and Imports", Issues in Foreign Exchange.

Israel within the global economy and is a result of both global and domestic forces. The continuing large-scale net export of investment in the financial account is a reflection of the growth in the current account surplus[2], which directly increases the economy's sources of foreign currency, most of which are invested in debt instruments. This is in addition to the process of structural demand for investment abroad. The surplus in the export of investment in the financial account is explained by the fact that the economy doesn't use its sources for only consumption or local investment, but also for saving abroad. The preference of the economy for saving abroad has been facilitated during the last two years by the removal of restraints on the export of capital.

The financial account was influenced by global trends in direct and financial capital flows.

The financial account was influenced this year primarily by the trends and basic conditions in the global economy, most of which are cyclical. This year, the global trend in direct investment, mergers and acquisitions continued. Also affecting the financial account were real influences originating in the global economy. First among these was growth driven by the expansion of world trade which increased the volume of capital looking for an investment and the level of corporate profitability. These factors encouraged direct investment by nonresidents. The reforms, which removed the restrictions on the export of capital and increased the exposure of Israeli residents to foreign financial assets, raised the level of sensitivity to global financial trends among Israeli residents. The sharp declines of the share indices in the developing markets in May-June worked to slow the flow of financial investment in shares, both by Israeli residents abroad and by nonresidents in Israel. The lack of certainty regarding the behavior of yields abroad reduced the volume of investment in foreign bonds and thus affected the foreign investment mix of institutional investors, banks and the business sector.

Domestic factors—improved underlying economic conditions and government policy—supported capital flows into the economy.

Among the domestic factors that affected the components of the financial account, it is worth mentioning the positive economic fundamentals, mainly the continuing growth, the surplus in the current account that indirectly influenced foreign investment, expansion of the negative external debt, the downward trend in the fiscal deficit and the confidence in macroeconomic policy. This situation has provided additional encouragement for direct investment by nonresidents. Also at work were domestic structural factors that were manifested primarily through the policy of the government, whose influence on the financial account was substantial. The influence of the government is both direct, through privatization and the market makers reform, and indirect, through the equalization implemented last year of taxation on foreign and domestic assets, which eliminated the distortion in the allocation of investment and increased financial investment abroad. The Bachar reform, which, among other things, divested the provident funds and the mutual funds from the banking system, resulted in some of them being bought by nonresidents.

Nonresidents' investment concentrated on the purchase of private Israeli companies that are technology intensive and export oriented.

The investment by nonresidents was concentrated in the acquisition of private Israeli companies that are technology-intensive and biased towards exports. As mentioned above, this is part of the global trend in mergers and acquisitions. Foreign

[2] The discrepancies between the current and capital accounts and the financial account are statistical differences that reflect measurement errors both in the current account and in the financial account.

investment by Israeli residents was concentrated primarily in the transfer abroad of the surplus sources of foreign currency in the banking system which represented a continuation of the trend that began last year. The factors behind the increase in the banks' surplus sources include the surplus in the current account, which directly increased the foreign currency income of the business sector, the low level of the nominal shekel/dollar exchange rate and the negligible interest rate spreads between Israel and abroad, which encouraged the redemption of credit in foreign currency by the business sector. Additional reasons for the export of capital included the continuing process of international diversification of the public's asset portfolio (by institutional investors and households) and the continuing acquisition of foreign companies by Israeli multinationals as part of their adjustment to globalization.

A long-term comparison to countries that are similar to Israel in terms of wealth and level of technology ("peer group countries") shows that Israel, like other developing countries, is a net importer of foreign direct investment (FDI) which is due to the large number of technology-intensive companies that attract direct investment. However, the volume of net direct investment is relatively small. In recent years, an upward trend has been observed in direct investment, both incoming and outgoing (as a percentage of GDP), relative to the peer group countries. This has occurred against the background of the economy's positive conditions and the continuing integration of large Israeli companies within global activity.

During the last two years, there has been a rise in the proportion of direct investment that does not contribute directly to capital accumulation (through the transfer of ownership) which has been encouraged by, among other things, the privatization process. This is in contrast to the dominance of direct investment that involves direct capital accumulation during the period 2000–04, particularly in the hi-tech industries which experienced rapid growth worldwide during those years.

The appreciation of the shekel was evidence that the current account surplus was larger than the excess structural demand for foreign investment.

The shekel/dollar exchange rate and the shekel's effective nominal exchange rate, which is calculated according to the weights of Israel's foreign trade, appreciated during the year (by 9 and 4 percent respectively). Thus, the surplus in the current account, which was a result of global trends and the low level of the real exchange rate, was larger than the structural surplus demand for foreign investment and therefore created pressure towards net capital export alongside real exchange rate appreciation. For a full analysis of the range of factors that influenced the exchange rate during the period under review, see the section on developments in the shekel-foreign currency market in Chapter 4.

2. THE CURRENT ACCOUNT

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

The surplus in the current account in 2006 totaled $6.8 billion which represents 4.9 percent of GDP. This compares to a surplus of 3.3 percent in 2005 and still smaller

surpluses in 2003 and 2004. This is the fourth year in a row that Israel has had a current account surplus, which is the result of long-term change in the economy's saving and investment patterns. The main factors acting in the last two years to create the high surplus in the current account were the tax reform relating to investment abroad, the expansion of investment abroad by institutional investors, greater-than-expected public saving and similar rates of interest in Israel and the US, contributed to the increase in the current account surplus during the last two years through pressure towards nominal and real depreciation. The process of real appreciation, as a mechanism for balancing the current account surplus, began recently as a result of the level of the current account surplus which is higher than that required to finance the net demand for investment abroad.

The main reasons for the surplus in the current account in the last two years were the tax reform on investments abroad, higher than expected public savings, and a domestic interest rate similar to the rate in the US.

A current account surplus, in particular during a period of rapid growth, is a new phenomenon in the Israeli economy. It has occurred in the past during recession years and immediately following the Economic Stabilization Plan of 1985 but never lasted more than two years in a row. The present current account surplus, despite the rapid rate of growth, is a result of the important part played by exports in leading growth, together with the effects of the short-term forces described above which support a low real exchange rate.

The transition to a current account surplus in recent years reflects, in addition to the factors described above, long-term factors acting to reduce the structural deficit in the current account that prevailed till the beginning of the 2000s, and even to turn it into a surplus. These include: (a) the reduction in the number of immigrants in the population and in the net migration balance to Israel (immigrant arrivals minus Israelis who leave the country), which began to affect the current account as early as in 1998. The structural deficit in the current account characterized Israel as a young country absorbing immigrants, and is attributable to the investment in their absorption—both by the private sector and the government—and the low rate of saving that characterized the immigrants during their first years in Israel. In contrast, the net migration balance during the last two years stood at only 0.2 of a percentage point of the population, which is lower by more than a percentage point than it was in the mid-1990s, lower by 0.3 of a percentage point than it was in 1970s and somewhat higher than it was in the mid-1980s. According to the estimates of the Bank of Israel during the period of immigration (Box 2.1 in the Bank of Israel Annual Report for 1998), it appears that the drop in the net balance of immigration relative to the mid-1990s is responsible for a reduction in investment of some 3 percent of GDP.[3] The extent of this effect on the current account via the increase in savings is difficult to assess; (b) structural change in the economy that acts to reduce the proportion of physical investment in GDP and to increase the investment in human capital, which is

The switch to a surplus in the current account was caused not only by the forces described above, but also long-term forces that have the effect of reducing investment and increasing savings.

[3] This calculation is consistent with another that assesses the investment required to maintain a fixed ratio of capital stock per worker. This is based on the simplified assumption that a reduction of one percent in the rate of population increase, when the ratio of capital stock to GDP is equal to 3, implies a required reduction in investment of 3 percent of GDP in order to maintain a fixed ratio of capital stock per worker.

Table 7.2
Background Conditions to the Balance of Payments—International Trade, the Real Exchange Rate, and the Terms of Trade, 1995–2006

	1999-2002	2003	2004	2005	2006
	(rate of change, percent)				
World trade					
Volume increase, goods and services	7.0	5.3	10.6	7.4	8.9
Volume increase, goods	5.2	6.3	10.9	7.5	9.4
Prices of manufactured goods (current dollars)	-2.5	14.2	9.4	3.6	2.2
	(nominal rate of change, current dollars, percent)				
Imports of The US and EU					
Low-tech industries	4.1	11.8	13.0	7.7	8.0
Medium-low-tech industries	3.0	15.5	25.1	11.1	25.7
Medium-high-tech industries	5.2	11.2	15.3	9.3	11.7
High-tech industries	4.8	10.9	17.5	9.0	7.2
	(indices)				
Relative prices					
Export prices/GDP prices	102.4	103.8	105.1	106.6	106.5
Import prices/GDP prices	101.6	107.2	112.3	116.6	118.3
Real exchange rate based on the CPI[a]	104.3	117.9	125.4	128.1	127.7
Terms of trade in the goods account[b]	100.8	96.8	93.6	91.4	90.0
Goods export prices[c,d]	99.5	100.1	104.1	106.6	109.4
Goods import prices[c,d]	98.3	104.5	113.0	120.4	126.2
Fuel import prices[c]	84.6	99.9	127.0	175.5	206.4

[a] The ratio of prices abroad multiplied by the nominal exchange rate to domestic prices.
[b] Export prices divided by import prices.
[c] Prices in current dollars, year 2000 = 100.
[d] Excluding ships, airplanes and diamonds.
SOURCE: World trade—IMF, World Economic Outlook, September 2006; imports from advanced economies—United States International Trade Commision, Comext-Eurostat; relative prices—data of the Central Bureau of Statistics and the IFS (International Financial Statistics of the IMF).

recorded in the National Accounts as a reduction in saving. These effects should offset each other, but in the light of individuals' liquidity constraint and their uncertainty regarding the return to education, the reduction in physical investment is the stronger effect, so that in the overall calculation the structural change acts to reduce the deficit in the current account; (c) the reduction in the size of the welfare safety net, which increases individuals' uncertainty regarding their future economic situation and tends to increase private saving; (d) the reduction in the cyclically-adjusted government deficit relative to the 1990s, which increases national savings and thus influences the current account. Although it is generally assumed that in the long run, individuals will discount the influence of the government, empirical studies indicate that within a term of five years, an increase in public savings will still influence the current account; and (e) the decrease in net foreign liabilities, which reduces the net payments on

liabilities[4] and thus reduces the risk of a crisis in the economy, and thus reduces also the payments to foreign investors on imported capital.

In contrast to the forces that work to increase the current account surplus, the factors that act to increase the deficit include the taxation of capital, which works to reduce saving, and the reduction in current transfers to the economy. In view of the observed trends, it can be concluded that these factors are secondary in importance.

An analysis of long-term trends also indicates the long-term change in the current account that dates back to the period after the Economic Stabilization Plan of 1985.

An examination of long-term trends also reveals the long-term change in the current account and its components, which already began following the Economic Stabilization Plan (Table 7.3, Figure 7.1). In only one year (1987) out of the eight following the Stabilization Plan did the current account deficit exceed 2 percent of GDP. During the period 1993–7, the growth in the current account deficit was the result of several factors, including the wave of immigration, the Oslo Accords and the peace treaty with Jordan, a substantial government deficit and a reduction in current transfers, which brought about an expansion of investment in the economy and a reduction in saving. Since 1998, the deficit has not exceeded 1.5 percent of GDP and during the last four years there has even been a surplus.

Israel's current account surplus is exceptionally high by international standards too.

An analysis of the developments in the current account from an international perspective shows that the current account surplus in Israel this year was exceptionally high. Table 7.4 can help us determine whether a surplus of greater than 4 percent of GDP in the current account is large relative to other countries. The table presents the percentage of observations in which the current account surplus in other countries

Table 7.3
The Current Account: A 30-Year Perspective, 1975–2006

(percent of GDP, annual averages)

	Current account	Goods and services account	Goods account	Services account	Revenue account	Current transfers
1975-1984	**-6.2**	**-13.8**	**-15.2**	**1.4**	**-4.6**	**12.2**
1975-1979	-6.0	-16.2	-17.9	1.7	-4.0	14.2
1980-1984	-6.5	-11.4	-12.5	1.1	-5.3	10.2
1985-1992	**0.0**	**-6.1**	**-6.7**	**0.6**	**-4.9**	**11.0**
1985-1986	3.9	-5.4	-7.5	2.0	-7.5	16.8
1987-1992	-1.3	-6.4	-6.5	0.1	-4.0	9.1
1993-1997	**-4.2**	**-7.5**	**-6.8**	**-0.7**	**-3.2**	**6.5**
1998-2006	**0.7**	**-1.3**	**-3.1**	**1.8**	**-3.4**	**5.5**
1998-2002	-1.0	-2.4	-3.6	1.2	-4.4	5.7
2003-2006	3.0	0.0	-2.6	2.6	-2.2	5.2

SOURCE: Based on Central Bureau of Statistics data.

[4] Investment abroad increases interest and dividend payments received by the economy but when they are at the expense of investment in the local economy, they harm its productive capacity and future exports.

exceeded 4 percent of GDP in a specific year during various periods between 1980 and 2006. The full sample, which includes the whole period and the vast majority of the countries in the world, contains approximately 4,400 observations.[5] It can be seen from the table that between 1980 and 2006, about 15 percent of the observations show a current account surplus of more than 4 percent of GDP. Some of these observations are the result of the inclusion of the oil-exporting countries which save significant amounts in periods of high oil prices. If the oil exporters had not been included, less than 10 percent of the observations would have shown a current account surplus of more than 4 percent of GDP.

The division of countries into two groups—countries that had a foreign asset surplus during the first half of the 1980s and countries that had net liabilities during the same period—also indicates that Israel's current account surplus this year is indeed exceptionally large. The table clearly indicates that countries with a foreign asset surplus tend to have a much larger current account surplus than countries with net foreign liabilities.[6] During the full sample period, 23 percent of the observations for countries with a foreign asset surplus (not including oil exporters) had a surplus of more than 4 percent of GDP as compared to only about 7.6 percent of the observations for countries with net foreign liabilities. In Israel, which as already mentioned, has net foreign liabilities, the current account surplus of 4.9 percent of GDP is therefore indeed exceptionally large.[7]

Nonetheless, Table 7.4 also points to a global phenomenon that to some extent diminishes the uniqueness of Israel's current account deficit this year. Thus, the percentage of observations of countries with a current account surplus of more than 4 percent of GDP increased significantly during the 2000s. The classification of countries into two categories according to degree of openness to capital flows helps illustrate this phenomenon. Thus, among the group that is more open to capital flows, including Israel, the percentage of countries with a current account surplus exceeding 4 percent of GDP ranged from 20 to 25 percent during the 2000s.[8]

The appreciation of the real exchange rate is the main mechanism that can be expected to work towards the reduction of the current account surplus; however, as long as there are forces in the economy that encourage net capital export, the current

[5] Includes 181 countries over a period of 27 years. There are missing observations for some of the countries due to a lack of data or because they only became independent during the sample period.

[6] A similar result is obtained when countries are classified into two groups according to their foreign assets and liabilities during the first half of the 1990s.

[7] The proportion of current transfers in Israel is particularly high (about 5.3 percent of GDP in 2006) in international terms and therefore contributes to the current account surplus. However, despite current transfers at levels of from 5 to 9 percent of GDP in the 1990s and even higher levels during the 1980s, Israel's current account was in deficit during most of those years.

[8] The classification of countries according to openness to capital flows was carried out using the proportions of direct investment and foreign investment in the securities portfolio of local residents and investment by foreign residents in the local economy as a percentage of GDP. According to this measure, Israel is classified as open during the 2000s. Thus, it is located in the 64th percentile among 89 countries (excluding oil exporters). The percentage of observations in which the current account exceeds 4 percent of GDP is dependent on the definition of openness.

Table 7.4
Number of Years when Countries' Current Account Surpluses Exceeded 4 Percent of GDP[a]

(percent, by selected groups)

	1980-06	1980-89	1990-99	2000-06
Total (181)	14.2	12.8	11.0	20.2
Countries for whom IIP[b] data for 1980–85 are available (112)	14.9	12.3	11.1	24.1
Countries with surplus foreign assets (20)	35.7	35.5	24.0	52.9
Countries with surplus foreign liabilities (92)	10.4	7.3	8.3	17.9
Countries, excluding oil exporters, for whom IIP[b] data for 1980–85 are available (94)	9.6	7.4	7.8	15.2
Countries with surplus foreign assets (11)	22.8	21.7	16.7	33.3
Countries with surplus foreign liabilities (83)	7.6	5.4	6.5	12.5
OECD countries[b] (27)	12.1	6.7	12.2	19.6
Countries with surplus foreign assets (7)	20.1	15.7	20.0	26.5
Countries with surplus surplus foreign liabilities (20)	9.3	3.5	9.5	17.1

[a] The number in parentheses is the number of countries in the group. The total number of observations is the number of countries multiplied by the number of years minus missing observations.

[b] The division into countries with surplus foreign assets and surplus foreign liabilities is based on the average for 1980–85.

SOURCE: Data on countries' foreign assets and liabilities; Lane and Milesi-Ferretti (2006), "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004."; Countries' current account data; World Economic Outlook, September 2006. Current account data for 2006 are estimates.

account surplus serves as a source of financing for the export of capital and no real appreciation can be expected. Indeed, the current account surplus in recent years has not led to a real appreciation. During the years 2004 and 2005, there was in fact a real depreciation that encouraged the expansion of the current account surplus for the financing of foreign investment by Israeli residents.

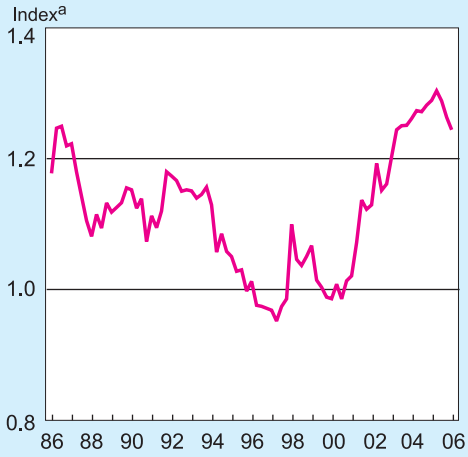
In the second quarter of 2006 a process of real appreciation started, indicating that the current account surplus was greater than that required to finance Israelis' net investment abroad.

The process of real appreciation, which began in the second quarter of 2006 and has now lasted three quarters, indicates that the current account surplus is larger than required for the financing of net foreign investment by Israelis. The real exchange rate according to the PPP approach appreciated during the last three quarters of the year by 4 percent. The real exchange rate, which is measured as the ratio of export prices to GDP prices or as the ratio of import prices to GDP prices, appreciated during the same period at a similar rate. It is possible that the magnitude of the real appreciation during the second half of the year was affected by the rise in the Bank of Israel rate of interest at the beginning of the year and its reduction only towards the end of the year. Despite the real appreciation during the course of the year, the average real exchange rate during 2006, according to its various definitions, remained close to its average level in 2005. According to the PPP approach it appreciated by 20 percent relative to the second half of the 1990s and by 10 percent relative to the first half of the 1990s (Figure 7.3). The continued growth in exports, as a result of foreign demand or an improvement in

productivity in the tradables industries, is expected to support the continuation of real appreciation.

The terms of trade in the goods account, which are defined as the ratio of prices of export goods to the prices of import goods (without ships, airplanes and diamonds), worsened this year by about two percent (Table 7.2). This represents a continuation of the significant deterioration in previous years. The worsening in the terms of trade is a result of the increase in the price of fuel. If energy prices are not taken into account, the terms of trade actually improved this year and reached a level that is lower by only about 2 percent from that during the period 1999–2002. The worsening of the terms of trade represents a decline in real income in that it reduces the quantity of imports that can be purchased for a given level of exports and thus works toward real depreciation.

Figure 7.3
Real Exchange Rate by the PPP Method, 1986-2006



[a] A rise in the index signifies a real depreciation.
SOURCE: Based on IFS data.

b. Exports

Goods and services exports (excluding diamonds) increased by 8.9 percent in 2006, faster than growth in GDP and business sector product.

The export of goods and services (excluding diamonds) grew this year by 8.9 percent, thus exceeding the rate of growth in GDP and business output. The rapid growth in exports in recent years has been the leading factor in GDP growth. The high-tech goods and services industries led the growth in exports again this year while the export of less technologically-intensive goods and services grew at a slower rate. In particular, the export of tourism services, which contributed one percent to the growth in the export of goods and services (excluding diamonds) during each of the previous two years, remained unchanged on average due to the effect of the war in Lebanon on the industry.

High-tech exports grew this year at a rapid rate of about 20 percent, which is similar to the average rate during the 1990s. The growth in the high-tech industries was led again this year by the pharmaceutical industry which grew by more than 40 percent. During the last decade, the pharmaceutical industry has grown rapidly at an annual rate of more than 20 percent and its share of high-tech exports has increased during those years to about one quarter. The electronics industry[9] also grew at a relatively rapid rate of 18 percent this year, following a slowdown in growth last year.

[9] This includes electronic components, electronic communication equipment, equipment for monitoring and control industries and medical and scientific equipment.

Table 7.5
Goods and Services Exports, 1995–2006

	2006		Volume change (percent)				
	Composition (percent)	$ billion	1999-2002	2003	2004	2005	2006
Goods and services	100	63	4.8	7.8	17.5	4.1	5.2
Goods and services excluding diamonds	86	54	4.1	8.1	19.1	6.1	8.9
Manufacturing exports (excluding diamonds)[a]	47	29	6.1	3.3	17.6	5.0	11.7
High-tech industries	23	14	9.3	0.9	23.1	10.0	19.9
Medium high-tech industries	12	8	4.5	3.1	10.3	-0.5	0.9
Medium low-tech industries	8	5	3.0	8.9	18.9	0.3	7.1
Low-tech industries	3	2	0.4	3.0	8.9	0.8	-0.7
Diamond exports	14	9	8.3	6.4	10.3	-6.1	-16.2
Services exports	31	19	4.8	14.3	22.2	8.2	7.1
Of which: Tourist services[b]	3	2	-24.9	14.7	36.8	29.6	-5.2
Other services[c]	20	13	15.6	14.9	22.9	4.1	13.2

[a] Foreign trade data.These data are not consistent with the balance of payments data because in this table they do not include exports to the Palestinian Autonomy and also because of statistical adjustments.

[b] After deducting expenditure in Israel by foreign workers.

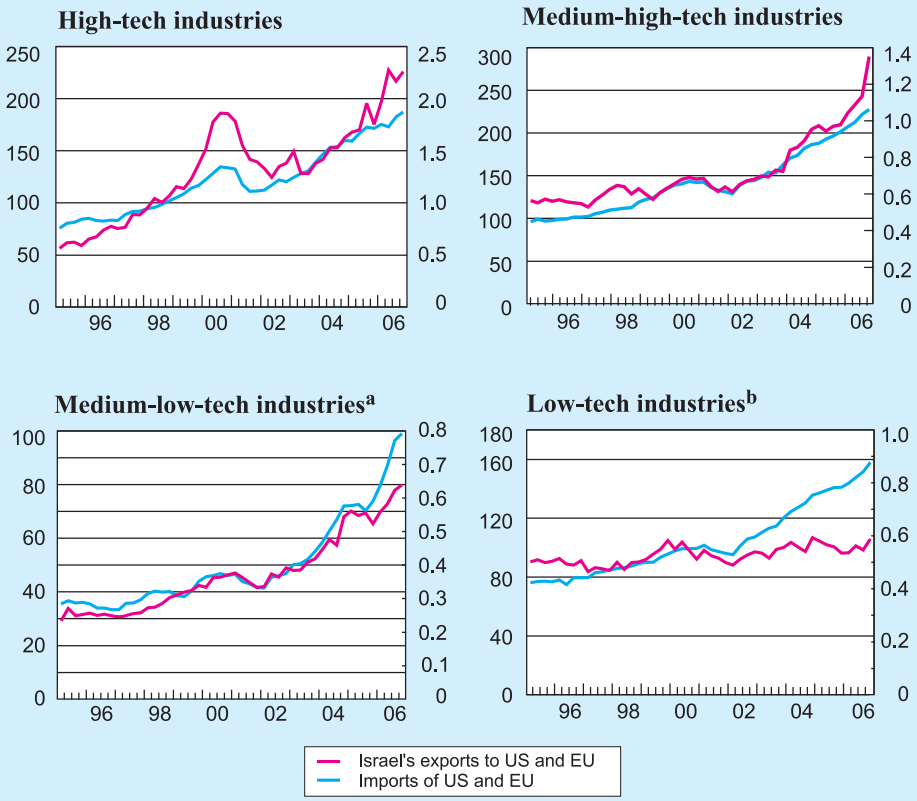
[c] According to balance of payments definitions, excluding insurance services and transportation services.

SOURCE: Central Bureau of Statistics.

The rate of growth of world trade in the past three years compared to the preceding three years contributed about 2 percentage points a year to the rise in exports.

The volume of global trade is an important variable in determining Israel's level of exports. The analysis of an export equation that examines the effect of changes in relevant vaiables on export development, shows that the growth in global trade in the past three years, in comparison to the preceding three years, contibuted to an expansion in exports in recent years of about 2 percentage points a year. Figure 7.4 presents Israel's manufacturing exports to the US and the EU according to technology intensity relative to the imports of those countries, which together account for about 60 percent of total world imports of manufactured goods. The figure shows the close correlation between Israel's exports to the US and the EU, and US and EU total imports of high-tech, medium-high- and medium-low-tech industries. These correlations point to the importance of the volume of global trade in determining Israel's level of exports. Of interest is the relationship between Israel's exports and the imports of the US and EU in the medium-to-high and medium-to-low technology industries. Thus, a relatively slow rate of growth in the exports of these industries reflects low growth of world demand for their products. Israel's market share in US and EU high-tech imports increased during this last year, which primarily reflects the increase in pharmaceutical exports. In contrast, there was noticeable weakness in the exports of low-tech industries, which is the result of globalization and the growing competition from developing countries.

Figure 7.4
Israel's Manufacturing Exports to US and the EU compared to US and EU Imports, by Intensity of Technology, 1995-2006
($ billion, seasonally adjusted)

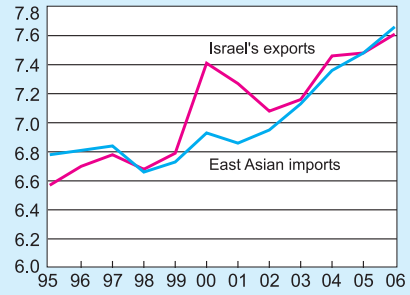


[a] Excludes mining and quarrying, jewelry, goldsmith and silversmith industries and articles n.e.c. (not elsewhere classified), according to the OECD definition of medium-low-technology industries.
[b] Includes jewelry, goldsmith and silversmith industries and articles n.e.c., according to the OECD definition of low-technology industries.
SOURCE: United States International Trade Commission and COMEXT-EUROSTAT.

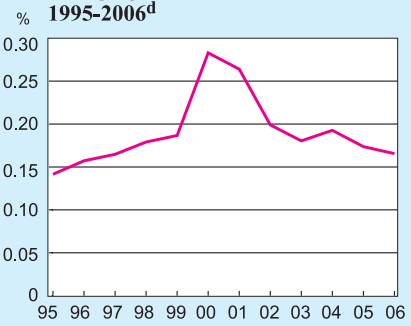
As part of the globalization process, Israel has been forced to deal with increasing competition from developing countries, primarily in industries that are intensive in labor and industries intensive in physical capital. On the other hand, it has benefited from the opening of new markets in the developing countries for the export of goods and services that are human capital intensive. Figure 7.5 presents the imports of emerging markets in East Asia relative to Israel's exports to these countries.[10] The figure shows the rapid growth in the imports of the emerging Asian markets at an

[10] These include China, India, Indonesia, Taiwan, Korea, Singapore, the Philippines, Malaysia and Thailand. The total GDP of these countries constitutes more than 90 percent of the total output of the Asian countries, excluding Japan.

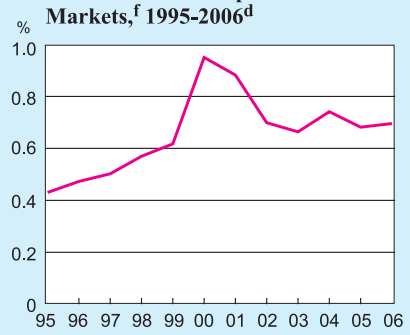
Figure 7.5
A. Israel's Goods Exports[a] to East Asian Emerging Markets,[b] and Those Markets' Goods Imports,[c] 1995-2006[d]
(Logarithmic scale)[e]



B. Israel's Goods Exports[a] as Share of Goods Imported[b] by East Asian Emerging Markets, 1995-2006[d]



C. Israel's Goods Exports[a] to East Asian Emerging Markets Relative to OECD Goods Exports to Those Markets,[f] 1995-2006[d]



[a] Excluding diamonds.
[b] China, India, Indonesia, Taiwan, South Korea, Singapore, Philippines, Malaysia and Thailand.
[c] Excluding fuel.
[d] 2006 data are estimates.
[e] The logarithmic scale is based on data in current dollars.
[f] Excluding Japan and South Korea, both of which are part of the East Asian geographical region.
SOURCE: Based on data from the Central Bureau of Statistics and the OECD.

average annual rate of about 15 percent in current dollars, as well as the increase in Israel's exports to those countries.

Despite the healthy rate of growth in Israeli exports to the emerging markets in East Asia in recent years, it has lagged behind the growth in these countries' imports and as a result Israel's share in their imports (Figure 7.5b) has fallen. The apparent reason for this is the rapid growth in regional trade in East Asia, particularly in the industries in which Israel does not compete. In order to neutralize this effect, we examined the share of Israel's exports to the emerging markets in East Asia within the imports of those markets from only the OECD countries (without Korea and Japan which are part of the regional trade). The figure shows the increase in Israel's share, as one of the developed countries, within exports to the emerging markets in East Asia and the resulting benefit to Israel from East Asia's integration within world trade.

The rise in services exports as a share of GDP is part of a long-term process, deriving from the combination of domestic developments and the increase in world trade in services.

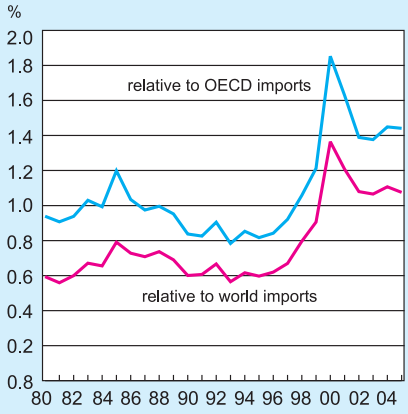
The export of services totaled $19.3 billion in 2006 which represents 14 percent of GDP. This compares to only 8 percent of GDP in 1996. The increase in the share of the export of services in GDP is part of the long-term process in the economy that involves a combination of local factors and the expansion of world trade in services. Following a decline in the export of services in 2001 and 2002 as a result of the worldwide recession in the high-tech sector and the Intifada, which seriously harmed tourism, the export of services grew at a healthy pace during the period 2003–5. This growth was led by tourism and high-tech services. In 2006, the export of services grew by 7 percent and the export of "other services" surged by 13 percent.

This year the growth in the export of services slowed due to the effect of the war on tourism during the second half of the year.[11] During the first half of the year, the revenues from tourism (cyclically-adjusted and excluding the living expenses of foreign workers in Israel) grew by $1.2 billion which represents an increase of 35 percent relative to the first half of 2005. With the outbreak of the Second Lebanon War, the nights stayed by tourists in Israeli hotels dropped by about 40 percent and the revenue from tourism was seriously affected. The figures on the number of incoming tourists in December indicate that even six months later the industry has far from fully recovered. According to Bank of Israel estimates, the decrease in tourism reduced GDP this year by 0.3 percent (see Box 2.2 in Chapter 2).

As with goods exports, exports of 'other services' are greatly affected by world trade in services.

The export of "other services", like the export of goods, is influenced to a large extent by world trade in services. The export of other services constitutes 66 percent of the total export of services and about 50 percent of this component is accounted for by the export of high-tech services. Figure 7.6 presents the export of Israel's other services as a percentage of the global import of other services and the import of other services in the OECD countries. The figure shows an increase in magnitude in the share of Israel's export of other services within world trade from 0.6 percent in the 1990s to more than one percent during the period 2002–5. This increase reflects a local development, i.e. the growth in the export of high-tech services in the late 1990s. It can also be seen from Figure 7.6 that the growth in exports of other services during the period 2003–5 at an average annual dollar rate of 14 percent, which supported the growth in GDP, primarily reflects a global development, i.e. the expanded world trade in these industries. It is reasonable to conclude that the increase in the export of other services by 17 percent in 2006 was primarily the result of this global development.

Figure 7.6
Israel's Other Services Exports Relative to Global and OECD Imports of Those Services, 1980-2005



SOURCE: Central Bureau of Statistics and the World Trade Organization.

c. Imports

Imports of goods and services (excluding diamonds) rose in volume terms by 5 percent in 2006, slightly slower than the rise in GDP and business sector product.

The import of goods and services (excluding diamonds) increased (in volume terms) by 5 percent, which is somewhat lower than the growth in GDP and business output. It is also lower than the rate of growth in imports last year. The relatively slow growth in imports is a reflection of the macroeconomic pressure within the economy towards

[11] The slowdown in the export of transportation services worked in the same direction. However, a large part of the export of transportation services involves the transport of cargo between foreign ports for which the value added to the Israel economy is relatively low.

the creation of a current account surplus. One of the main channels through which this pressure is manifested is the real depreciation.

The import of goods and services derived from local uses and the input-output coefficients is consistent with the actual growth in imports. This is evidence that the trend in imports this year is consistent with the trend in local uses—consumption, investment and exports—and that the effect of import prices on imported quantities is expressed in local uses and did not find its way to the demand for imports and import substitutes.

Net fuel imports in 2006 totaled $7.5 billion, 5.4 percent of GDP, compared with 2.6 percent of GDP in 2001 and 2002.

The net import of fuel[12] totaled $7.5 billion this year which represents 5.4 percent of GDP. This compares with 2.6 percent of GDP in 2001–2. The demand for fuel in the short- and intermediate-term is almost completely inelastic and price changes primarily influence the timing of imports. Despite a sharp cumulative increase of 140 percent in the price of oil during the past four years, it is still difficult to see any significant change in the quantity of fuel imported. Although the quantity of imported fuel declined this year, it followed a sharp increase in the import of fuel last year. Despite the inelasticity of demand, it is reasonable to assume that the high price of fuel will in the long term affect consumption as other factors of production and low-energy consumption products become more attractive. Thus, for example, the high price of fuel makes energy-efficient cars more attractive though it will take time for the proportion of these vehicles to become significant.

Table 7.6
Goods and Services Imports, 1995–2006

	2006		Volume change (percent)				
	Composition (percent)	$ billion	1999-2002	2003	2004	2005	2006
Goods and services	100	61.7	5.3	-1.0	11.9	4.6	2.0
Goods and services excluding diamonds	86	53.0	4.0	-2.3	11.4	6.1	5.0
Goods	76	46.9	5.3	-1.8	10.9	3.8	1.1
Goods (excluding fuel and diamonds)	50	30.8	4.1	-5.5	12.3	5.5	7.0
Consumer goods	10	5.9	4.9	-6.0	12.2	6.3	9.2
of which: Durables	4	2.5	2.3	-10.3	18.6	8.4	8.8
Production inputs[a]	30	18.5	1.5	-4.1	14.7	1.8	6.2
Investment goods	11	6.7	7.3	-11.4	10.3	8.0	6.9
Fuel	12	7.5	0.0	8.1	-4.2	8.7	-6.3
Diamonds	14	8.6	14.2	5.9	14.7	-3.3	-14.3
Services	24	14.8	5.4	1.1	14.7	6.6	4.4

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

[12] The import of fuel less the export of refined products.

The import of consumer durables increased this year by 8.8 percent, lower than the increase in the import of non-durable consumer goods. This contrasts with previous years of rapid growth in which the increase in the import of durable consumption products was faster than that of total imports of consumption goods. It is reasonable to assume that the real depreciation is slowing the growth of consumer durables imports. An additional reason, which is of a more technical nature, is the slowdown in the sale of private vehicles towards the end of the year in expectation of a reduction in the purchase tax and in the determining price of the license groups.[13]

Box 7.1
Global imbalance and Israel's current account

According to its definition, the current account for all countries, which for some countries is in surplus and for others is in deficit, must equal zero at any point in time.[1] In addition, the value of the export of goods and services, payment for factors of production and unilateral transfers is equal to the value of the import of goods and services, the revenues of factors of production and the receipt of transfers, respectively, since the exports of one nation are the imports of some other nation.

The term "global imbalance", the use of which is becoming increasingly widespread, refers to the huge deficit in the US current account and the corresponding saving surpluses of China and the oil exporters. In 2006, the US current account deficit totaled $840 billion, which represents 6.3 percent of GDP. This compares with a figure of 3.2 percent in 1999 and about 4 percent in 2000 and 2001. Such a large deficit in the current account, which is a reflection of a low rate of savings, is not sustainable and therefore most economists worldwide expect a significant change in relative prices in the US that will bring about a reduction in the current account deficit. From the point of view of imports and exports, the increase in the US current account deficit during the last five years reflects an increase of $450 billion in the deficit of the goods account relative to 2001. Of this, $180 billion was due to the increase in oil prices.

The US deficit is not the only factor contributing to global imbalance. Thus, the increase in the price of oil from an average of about $20 per barrel in the 1990s to about $65 in 2006, led to an overall surplus of some $500 billion in the current account of the large oil exporters[2] which represents close to 20 percent of their GDP and about 1 percent of world output.

[1] As a result of measurement problems and differences in definitions between countries, the current account of all countries in the world does not add up exactly to zero.

[2] According to the definition that includes 23 countries, which is that used in the World Economic Outlook published by the International Monetary Fund.

[13] Although there was a slowdown in the sales of vehicles at the end of 2005 as well, this year it appears to be more pronounced.

The increase in the US current account deficit has made it easier for many economies worldwide to create a current account surplus though the rise in the price of oil works in the opposite direction among oil-importing countries. Israel's current account is influenced by both these forces and it is impossible to determine which is dominant.[3]

In 2006, Israel's goods account with the US (excluding diamonds) was in a surplus of $4,4 billion as compared to a deficit of $1.5 billion in 1999, a deficit of $0.3 billion in 2001 and a negligible surplus in 2002. For purposes of comparison, Israel's goods account with the EU did not change significantly between 1999 and 2006.[4] Figure 1 presents total US imports of goods (without fuel and diamonds) starting in 1989, Israel's exports to the US and Israel's market share of US imports. The figure shows the importance of total US imports in the determination of Israeli exports to the US. Although in 2000 and 2001, as well as this year, the share of Israel's exports in US imports increased, overall the changes in the share of Israeli exports to the US have been small. On the assumption that the US current account deficit returns to the sustainable level of around 3.5 percent within a few years—through the reduction of the deficits with all US trading partners by similar amounts—Israel's surplus with the US will be reduced by about $2 billion, which represents 1.4 percent of GDP.

In addition to its direct influence, a future reduction in the US current account deficit will affect Israel through its indirect influence on the demand for imports in Third World countries. It is difficult to estimate the magnitude of this indirect effect but it is likely to be significant. A large part of Israel's exports to the developing countries consists of factors of production that are used as intermediate products in their exports to the developed countries, including the US. The reduction in the exports of the developing countries to the US is liable to lead to a drop in their demand for these factors of production.

The increase in oil prices during the last four years led to a sharp increase in Israel's expenditure on the import of fuel. In 2001 and 2002, Israel spent 2.6 percent of GDP on the import of fuel while during the last two years, the net import of fuel has amounted to 5.2 percent of GDP.[5] Whether the price of oil falls or whether it remains at its current level, the current account surplus of oil

[3] Although Israel's economy is relatively small, and is primarily influenced by global developments via global price ratios, past experience has shown that Israeli exports are affected by the volume of global trade, particularly by the demand in export markets, and not just by world prices of factors of production and the prices of Israeli goods with export potential. Therefore, it can be said that the sharp increase in US imports has contributed to the growth of Israeli exports.

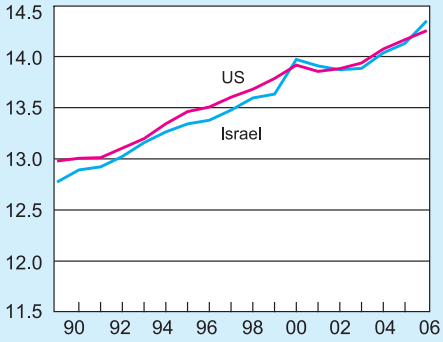
[4] In dollar terms. In euro terms, the deficit has declined by 0.7 billion.

[5] The figures are net of the export of refined oil products.

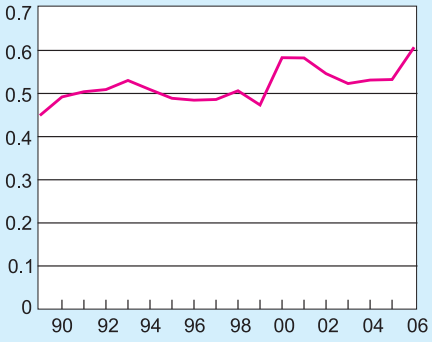
exporters is expected to diminish over time. If oil prices remain at their present high level, it is reasonable to assume that over time, the oil exporters will reduce their savings and will increase their imports. If oil prices fall, their income will be reduced. In any case, the reduction in the huge current account surplus of the oil exporters will work to increase the surplus (or reduce the deficit) in the current account of the oil-importing countries, including Israel.

Figure 1

A. US Goods Imports and Israel's Goods Exports to US, 1989-2006 (Logarithmic index,[a] excl. diamonds and fuel)



B. Israel's Market Share of US Goods Imports, 1989-2006 (excl. diamonds and fuel, percent)



[a] The logarithmic scale is based on data in current dollars.
SOURCE: Central Bureau of Statistics and United States International Trade Commission.

d. The income account

The net income account showed a $1.5 billion deficit in 2006 as compared to a deficit of $3.6 billion in 2004 and $1.7 billion in 2005. The improvement in the income account reflects an increase in net receipts on investment (interest, dividends and undistributed profits) and the lack of significant change in the net payments for wages.

Israel's net payments on investments has fallen in the last few years, and in 2005 the situation actually reversed to one of net receipts.

The net payments made by the economy on investment have fallen in recent years and in 2005 and 2006 they in fact became net receipts. The level of net payments on investment is determined by the economy's balance of net liabilities and the composition and return on assets. The process of massive capital export during the last three years has led to a drop in the balance of net liabilities that has significantly decreased the payments made by the economy on capital. In addition, since the

economy is a net asset holder in debt instruments, the rise in interest rates abroad has significantly increased the net interest receipts of Israeli residents.

The sharp changes in the economy's balance of foreign liabilities, i.e. the drop in the balance of liabilities in equity instruments and the increase in the asset surplus in debt instruments, do not, however, provide a full explanation of the transition from net payments on capital to net receipts. Furthermore, since the economy has a balance of net liabilities, where most of the foreign assets of Israeli residents are held in the form of debt instruments that have relatively low yields and half of the foreign liabilities of Israeli residents are in equity instruments that are expected to have relatively high yields, it is doubtful whether the positive level of the economy's net receipts on capital will continue.

Despite the sharp changes in the balance of foreign liabilities, they do not fully explain the transition from net payments on capital to net receipts.

The net foreign payment for labor totaled $1.9 billion in 2006 which represents 1.4 percent of GDP. The payment to foreign workers (including Palestinians) totaled $2.4 billion this year while the payment to Israeli workers abroad totaled $0.5 billion. In recent years, there has been a downward trend in Israel's payment for foreign labor in terms of GDP. This is the result of a number of factors: the drop in the number of foreign workers at the beginning of the decade and the stability in their numbers during the last two years; the growth in GDP relative to the stability in the wages of foreign workers, which is a result of the high rates of unemployment among uneducated workers and the weak bargaining position of these workers; and an increase in the payments to Israeli labor abroad.

e. Current transfers

Current transfers totaled $7.4 billion in 2006 which represents 5.3 percent of GDP. In the 2000s, the annual average of current transfers was 5.4 percent of GDP as compared to 5.8 percent during the second half of the 1990s. This year, in contrast to the long-term trend, current transfers as a percentage of GDP were higher than last year by more than one percentage point. This reflects an increase of $0.8 billion in US defense aid and an increase in donations.

In international terms, the volume of current transfers to Israel is relatively high. Among its four sources, i.e. aid from the US government, compensation from Germany, donations and private transfers, three are expected to decline over time. Thus, US aid has declined during the last decade by $0.6 billion in nominal terms and starting from next year it is expected to stabilize at a nominal level of $2.4 billion per year (where stability in nominal terms represents a decline in real terms). In addition, compensation from Germany is also expected to diminish over time. And finally, individuals' transfers are expected to decline since some of this component represents transfers of new immigrants, whose numbers are diminishing over time due to reduced immigration.

3. THE FINANCIAL ACCOUNT[14]

a. The net financial account and the main factors affecting it

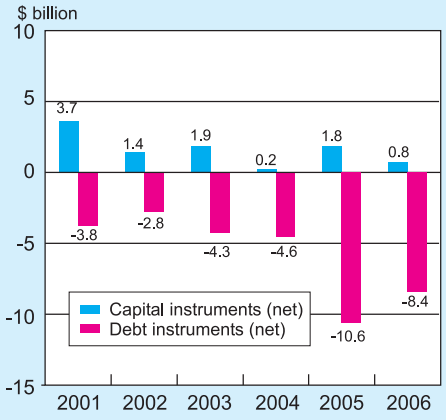
The net financial account (investment by nonresidents in Israel less foreign investment by Israeli residents) totaled $7.6 billion in 2006, with a significant expansion of foreign investment by Israeli residents and of investment by nonresidents in Israel to record levels ($32.1 billion and $24.5 billon respectively; Figure 7.2). This represents a continuation of the upward trend in the net export of investment and the expansion of investment flows in both directions. This trend, which began in 2002, reflects the continuing process of integration of Israel within global markets, which is the result both of the globalization process and the worldwide trend in direct investment, and the influence of local factors, foremost among them the structural changes that have reduced the restrictions on the export of capital.

There were two large transactions this year involving large-scale direct investment—one involving an Israeli company and the other a foreign company—which significantly increased gross investment. Nonetheless, their direct influence contributed to a net import of capital of only $0.7 billion.[15]

An analysis of the net financial account by type of investment (Figure 7.7) shows that this year, as in the past, there was net capital export of debt instruments (deposits, bonds and credit) and net capital import of equity instruments (shares—both directly and in portfolios—and in real estate). The export surplus of investment in debt instruments, which reflects an increase in foreign net liabilities to Israel, indicates that the current account surplus was dominant in its effect on the export of capital since the surplus in export revenues is received in cash and usually deposited in debt instruments. Incoming investment in equity instruments reflects an improvement in the division of the economy's risk between Israel and abroad.

The export surplus of investment in debt instruments indicates that the current account surplus was dominant in its effect on the export of capital.

Figure 7.7
Financial Account (Net) by Instrument of Debt or Capital, 2001–2006



SOURCE: Based on company and bank reports.

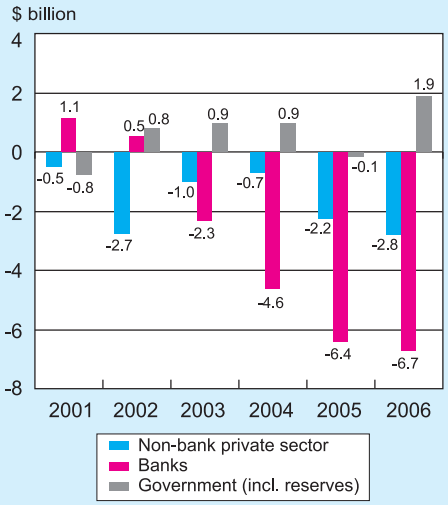
An analysis of the net financial account according to sectors (Figure 7.8) shows that the trend of capital export

[14] There may be discrepancies between the data in this section and that in the Statistical Appendix, due to changes in timing.

[15] The Teva-IVAX deal and the purchase of Iscar. The gross effect of these two deals together totaled about $11 billion in investment by Israeli residents and about $12 billion in investment by foreign residents.

has been led in recent years by the banks. The deposits and credit from the banking system serve as channels for the management of the demand and supply of various sectors for foreign currency. This year, the surplus in the sources of foreign currency of the business sector increased as a result of the improvement in the current account which, along with other factors, increased the demand for bank deposits by households and nonresidents (for further discussion, see Section c, Foreign Investment by Israeli Residents).

Figure 7.8
Net Financial Account by Sector, 2001-2006



SOURCE: Central Bureau of Statistics.

Net foreign direct investment (FDI), which consists of direct investment by nonresidents in Israel less the foreign direct investment by Israeli residents, totaled about $0.5 billion this year, compared with $1.4 billion in 2005. A long-term analysis[16] of net direct investment indicates that it totaled about $11 billion during the period 1998–2005. A comparison to developed and developing countries that are similar to Israel (the "comparison countries"[17]) shows that, as in the developing countries, net direct investment in Israel is positive in contrast to the negative net direct investment in the developed countries. Positive net direct investment reflects the desire of global companies to take part in the growth of the emerging countries and to purchase profitable technology-intensive companies. However, net direct investment in Israel is relatively low[18] partly because unlike most emerging markets, Israel does not have natural resources, and privatization is on a fairly limited scale. Moreover, Israel has certain characteristics of a developed economy and there are a number of multinational companies operating in Israel that in recent years have become global players that invest abroad.

Israel, like the developing countries, is a net importer of direct investment, although the level in israel is relatively low.

The financial account was affected this year by long-term factors and some of the trends that began last year continued in 2006. Some of the main processes this year

[16] There is high annual volatility in this variable since it is influenced by a relatively small number of large transactions.

[17] The Israeli economy combines characteristics of an emerging economy and those of a developed economy. (There are bodies, such as the IIF, which categorize Israel—with respect to direct investment—as an emerging country while other bodies, such as UNCTAD, categorize it as a developed country in this regard.) In our opinion, the relevant countries are those that have a similar per capita GDP (2002) and a similar level of technology as measured by the ranking of technological achievements (World Economic Outlook 2002). Developing countries: Poland, Slovenia, Hungary, the Czech Republic, Singapore and Korea. Developed countries: Portugal and Spain.

[18] Among the developing countries that are similar to Israel, Israel is ranked sixth (out of seven) in volume of net direct investment during this period (even if it is measured as a percentage of GDP).

influenced the volume of investment while others influenced the mix of investment. The global factors, which are primarily cyclical, were dominant in their influence on the volume of direct investment and their effect was in addition to the strong influence of the government on the financial account.

Influenced by a global trend, direct investment expanded considerably this year, including investments by private equity funds.

The influence of global trends in financial markets and of real activity:[19] In 2006, there was an increasing global trend of mergers and acquisitions which reached record levels.[20] This trend was supported by global growth and relatively low rates of interest, which increase the volume of capital searching for yield, and a decrease in the level of risk. During the last two years, the merger and acquisition deals have been characterized by a high degree of involvement by private equity funds[21] which have increased the proportion of cash in the financing of deals. The worldwide trend of mergers and acquisitions has supported the expansion of direct investment. In recent years, the share of the emerging nations has increased in both the total absorption of direct investment worldwide and the export of this investment. In recent years, this direct investment has been concentrated in the service industries, primarily financial and communication services, in real estate and in the technological industries. Israel, as a developing country, has a small and open economy that is influenced first and foremost by global trends and therefore there exists a correlation between the value of worldwide mergers and acquisitions and direct investment in Israel. This year, direct investment in Israeli companies by nonresidents, including private equity funds, increased significantly.

Global growth influenced the financial account through several channels: directly, through the increase in revenues from the exports of Israeli companies, primarily in the technological industries, which were deposited with the banks and invested in financial assets abroad; and indirectly, through the influence of the current account surplus on the assessment of the Israeli economy's risk by nonresidents.

The lack of certainty in the markets regarding the monetary policies of the leading economies and, as a result, regarding the future trend in yields, has made investment in bonds less attractive and has thus had an influence on the composition of investment abroad. Institutional investors have preferred to invest in shares and other investments while banks have preferred deposits. In May and June, there was a massive capital outflow from emerging economies as a result of fears of a major slowdown in real activity and, as a result, the prices of financial assets plummeted in the emerging

[19] The survey of international developments is based on: Global Financial Stability Report, September 2006; WEO, September 2006, IMF; Capital Flows to Emerging Market Economies, Institute of International Finance, September 2006, IMF.

[20] In 2006, deals were announced amounting to $3.8 trillion. Source: www.dealogic.com and Thomson Mergers and Acquisitions Review.

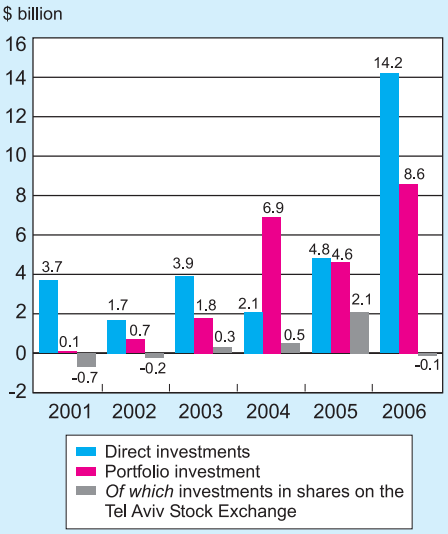
[21] These are financial service companies that bring together several investors, primarily institutional but also private. They constitute the operational arm for the purchase and takeover of firms. As opposed to traditional direct investment, these funds are not interested in long-term activity and the average duration of their ownership until sale is about 5 years. During the last two years, 20 percent of the value of merger and acquisition deals worldwide involved private equity funds. Source: World Investment Report 2006, Box I.5 and Thomson.

economies and global investors became more risk-averse. The drop in prices in the markets and the decrease in global liquidity contributed to the slowdown in financial investment by nonresidents in Israeli shares in the secondary markets, both in Israel and abroad, and by institutional investors and households in foreign shares.

Domestic influences: Consolidation of the positive conditions—growth, a reduction in the fiscal deficit, an expected improvement in rating, a positive trend in the negative external debt and confidence in macroeconomic policy—made investment in the economy more attractive to nonresidents and contributed to the continuation of foreign investment despite the second Lebanon war. The increase in private saving—against the background of a booming economy (due to consumption-smoothing considerations) and the expectation of a future deterioration in the situation[22] and the removal of the restrictions on the export of capital—encouraged the export of investment abroad. Government policy supported the import of capital again this year and its direct influence was even larger than it was last year. The market makers reform increased the investment of nonresidents in government bonds, and they reached a record level. Following a record level in 2005, in which assets worth $2 billion were privatized (most of which were purchased by nonresidents), the government this year privatized assets with a value of one billion dollars, of which $0.4 billion worth was purchased by nonresidents.[23] The Bachar Reform indirectly encouraged the import of capital and led to increased interest by nonresidents in Israeli companies for purposes of portfolio management and, in several cases, for purchase.

The market makers reform increased nonresidents' investment in government bonds, which reached record levels.

Figure 7.9
Nonresidents' Investments in Israel, Direct and Portfolio, (including on Stock Market), 2001-2006



SOURCE: Based on company and bank reports.

b. Investment in Israel by nonresidents

Investment by nonresidents in shares, bonds, real estate, credit and deposits in Israel (Figure 7.9) totaled a record $24.5 billion this year as compared to $9.8 billion last year. The main part of the increase was due to the following factors: the purchase of private Israeli companies in the technology-intensive industries; the investment by nonresidents in shares and tradable bonds as a result of the financing of a large direct investment of an Israeli company through the issue of shares and

Nonresidents' investment in Israel reached a record $24.5 billion this year.

[22] For further discussion of the short- and long-term factors behind the increase in private saving, see Chapter 2, Section 4.

[23] The controlling shares of Discount Bank and 6 percent of Leumi Bank.

bonds[24]; the expansion of investment by nonresidents in government bonds with the institution of market makers; and the increase in deposits by nonresidents in Israel. On the other hand, nonresidents sold shares on the Tel Aviv Stock Exchange and abroad as a result of the global effect of the capital flight from the emerging economies and the local geopolitical events at the beginning of the year (the illness of the Prime Minister and the resulting early elections and the coming to power of the Hamas in the Palestinian Authority). The continuing slowdown in the primary share market in the US also affected the volume of shares issued by Israeli companies.

Foreign direct investment (FDI)

Foreign direct investment in the economy grew significantly in 2006 to a record level of about $14.2 billion.

Foreign direct investment in the economy grew significantly in 2006 to a record level of about $14.2 billion, as compared to $4.8 billion in 2005 (Figure 7.9). The main part of the increase in direct investment this year was the result of the purchase of non-traded Israeli companies ($10 billion) most of which were highly profitable technology-intensive companies. This occurred against a background of growth in these industries worldwide. Some of the deals resulted in the companies being off-listed, as was the trend worldwide.[25] We would mention that this component is influenced by a small number of large transactions and that the process to develop these deals is a long one. This year, a number of large deals were completed and therefore it is reasonable to assume that the process began last year. Therefore, one cannot use the volume of transactions this year as an estimate of the level of permanent investment.

Foreign direct investment is an important source of finance for the economy, and contributes to long-term growth.

Foreign direct investment is an important source of financing for the economy. Most of it involves equity instruments and therefore the risk they involve is transferred to nonresidents without any increase in the economy's debt. This investment is also less reversible; it transfers knowledge and technology to the target economy; and enables access to foreign marketing channels and sources of financing. Its contribution to long-term growth, according to most empirical research, is not in doubt and is primarily manifested in the indirect effects of the increase in capital, knowledge and technology on productivity. In contrast, its contribution to local investment is unclear since it only increases the source of financing and not its use.[26] According to a study done at the Bank of Israel,[27] an increase of one dollar in foreign investment entering developing countries, including Israel, contributes an average of $0.68 to local investment in the long term and $0.23 to growth. Therefore, direct investment during the last two years

[24] A large Israeli company financed the acquisition of a competitor by issuing shares with a value of $5.5 billion and bonds with a value of $2.6 billion.

[25] 2006 was a record year for the value of companies off-listed from world stock exchanges as a result of private acquisitions ($150 billion). This phenomenon is a reflection of the strong trend in mergers and acquisitions. Source: Thomson Review of Financial Mergers and Acquisitions.

[26] The effect of direct investment on local investment is generally categorized into two extreme situations: direct investment which is likely to displace local investment (crowding out) and direct investment which is added to local investment (crowding in), according to the economic environment of the host country.

[27] Y. Hecht, A. Razin and N. Shenar, Reciprocal Relations between Incoming Capital Flows, Local Investment and Growth, Issues in Foreign Exchange 2003.

can be expected to increase gross local investment in the long run by $14 billion and its net contribution to GDP is estimated at $5 billion (4 percentage points of growth).

Nonetheless, it is important to mention that direct investment is likely to also have disadvantages, primarily if a foreign company acquires a local competitor in order to "wipe out" or displace other local companies. In such a case, the owners are likely to receive fair value from their point of view but the economy will lose tax revenues and there will be negative effects on GDP and the labor market. This is in addition to the possible harm to the structure and competitiveness of the market. In another case, a foreign company that takes control of an Israeli exporter is liable to reduce transfer prices if the tax authorities find it difficult to regulate these prices. In this case, the main harm to the economy is the reduction in tax payments on profits. In addition, there are two partially offsetting effects on the current account: on the one hand, the reduction in transfer prices reduces export revenues but, on the other, it reduces payments for factors of production (profits).

In 2006 the high-tech industries were again the main target for direct investment.

A breakdown of direct investment by industry shows that in 2006 the high-tech industries were again the main target for this investment (about $7.7 billion as opposed to $2.2 billion last year) which was not the case in most developing economies.[28] A sizable portion of direct investment was concentrated in the traditional manufacturing sectors, primarily due the purchase of Iscar (for $4 billion). In addition, two deals with a value of $0.7 billion were made in which financial portfolio management companies were purchased by nonresidents as a result of the divestment of provident funds and mutual funds from the banks.

The direct investment in traded companies totaled $0.7 billion as compared to a record level of $1.4 billion last year, which was the result of the privatization of traded companies. It is worth mentioning the high degree of concentration of foreign direct investment in traded Israeli companies. Thus, two thirds of foreign direct investment is concentrated in only six Israeli companies in the financial, communication, real estate and chemical sectors. The share of foreign parties in interest in the total value of the Tel Aviv Stock Exchange rose by about one percent to a level of about 5.5 percent at the end of 2006.

The relative stability in other direct investment continued this year. In the long term, this type of investment—in startup companies (part of the investment in non-traded corporations), in real estate and in accumulated profits of non-traded Israeli companies controlled by nonresidents—has a low volatility. The direct investment in startup companies totaled about $0.85 billion this year, which is similar to its level in previous years. The volume of available capital for investment—which is the volume of investment that investors in funds are committed to—was stable and at the end of 2006 stood at $1.3 billion. The investment in real estate in Israel continued to grow this year and reached a record $1.4 billion. This trend in real estate investment began in 2003 and since then has totaled $4 billion.

[28] In most developing economies, direct investment is concentrated in natural resources and in the service industries, primarily financial services. World Investment Report 2006.

Direct investment is generally categorized into two types according to the direct effect on the capital accumulation in the target country: a) direct investment which involves direct capital accumulation, including new projects (greenfield), accumulated profits, investment in startup companies[29] and private issues (extension of capacity); and b) investment that does not involve a direct increase in capital accumulation and is carried out through the transfer of ownership (mergers and acquisitions). In general, according to empirical studies done worldwide,[30] investment that involves direct capital accumulation is considered to be preferable since the contribution of transferal of ownership to investment in the economy is ambiguous. The transfer of ownership is likely to indirectly increase investment through a number of channels: providing the acquired firm with access to foreign sources of finance for additional capital acquisition; additional investment in capital to improve and upgrade the acquired productive capacity; or reinvestment of the funds from the sale in a more efficient manner. Apart from that, it is possible that direct investment through transfer of ownership will be used to finance current expenses rather than physical investment. In any case, the main disadvantages are manifested in the short term. In the long term, the differences between the types of investment tend to blur since they both have indirect effects through the improvement in technology, productivity, management and access to financing.

The growth of the high-tech industries supported the rise in direct investment which contributes directly to capital accumulation.

A long-term analysis of the breakdown of direct investment according to its direct contribution to capital accumulation[31] (Figure 7.10) shows that the period 1995–2006 can be divided into two sub-periods which differ from each other in composition of investment: The first period, from 1995–1999, was characterized by low levels of direct investment that were dominated by investment through mergers and acquisition. The second period, from 2000–2006, was characterized by high levels of direct investment accompanied by an increase in the proportion of investment that directly increases capital accumulation. The difference between the two periods is a direct result of the expansion of the high-tech industries in Israel which led to a number of developments: the flow of capital from nonresidents for the purpose of enlarging the productive capacity of the Israeli companies; a stable level of investment in startup companies (an average of $0.8 billion annually); and the high level of profitability among firms in the high-tech industries. An analysis of the changes in the proportion of investment with a direct contribution to capital accumulation within total investment (a 4-year moving average) shows an increase in the proportion until 2004 and a decrease in the last two years, primarily due to the process of privatization.

[29] According to National Accounts data, the value of output that has not yet been sold in startup companies, which is the change in inventory (flow of gross investment), is estimated by the net investment figures in venture capital companies. Thus, in this case, the relationship between direct investment and gross local investment is one-to-one.

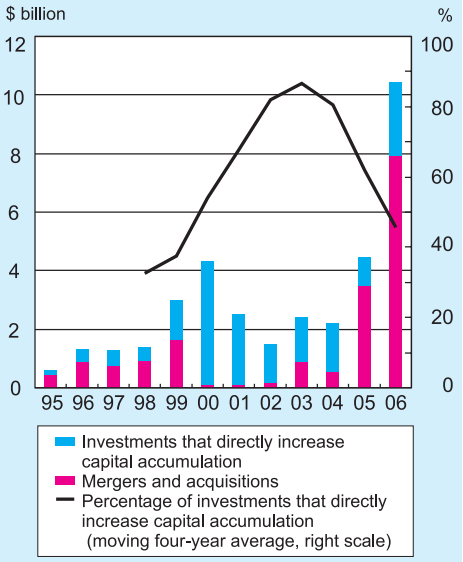
[30] Calderone et al. World Bank 2004; UNCTAD 2000.

[31] According to the breakdown, this accounted for 80 percent of total investment during the period 1995–2006.

Taking a long-term view, the rate of direct investment in Israel is lower than in the peer group countries.

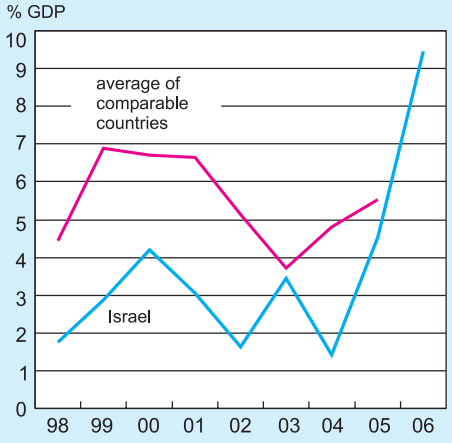
The upward trend in direct investment in Israel in recent years is supported by the worldwide long-term trend in direct investment in emerging economies (that began in 2003) which is the result of the improvement in the basic conditions in those economies, structural reforms, the increase in the price of goods and world growth. An international comparison of the volume of direct investment (in terms of percentage of GDP) in Israel relative to countries similar to it in per capita GDP and level of technology[32] (Figure 7.11) shows that the long-term average (1998–2005) of the rate of direct investment in Israel is lower than in the comparison countries (3 percent as compared to an average of about 5.2 percent). It is possible that this difference is the result of the Israeli economy's structural disadvantages relative to other emerging economies. These may include a relatively limited privatization process, a lack of natural resources, a lack of cheap labor and geographic distance from investing countries. However, during the last two years, local factors—first and foremost the positive economic conditions alongside the privatization process—have led to an increase in the volume of direct investment in Israel, such that the share of direct investment in GDP rose to 10.8 percent in 2006. Furthermore, the share of investment in Israel within total direct investment in all the emerging economies[33] has risen during the last two years to 6 percent, which is above the long-term average of 3 percent.

Figure 7.10
Nonresidents' Direct Investments by their Direct Contribution to Capital Accumulation, 1995-2006



[a] According to the dissection of about 80 percent of total direct investments.
SOURCE: Based on company and bank reports.

Figure 7.11
International Comparison of Nonresidents' Direct Investments, 1998-2006



SOURCE: Based on data from UNCTAD.

[32] See footnote 17.

[33] This is a measure of the economy's ability to compete. The group of emerging countries contains 31 countries (according to the IIF definition).

This increase reflects an improvement in Israel's ability to compete for direct investment.[34]

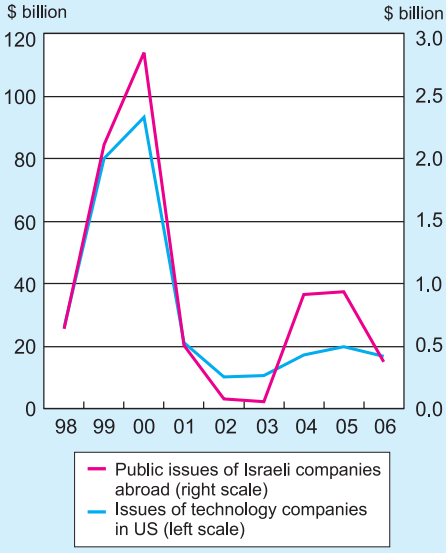
Portfolio investment

Portfolio investment by nonresidents grew this year to a record level of about $8.6 billion in comparison to $4.6 billion last year. Most of the investment was in the issues of a large Israeli company for the purpose of financing a direct investment and in the purchase government bonds by nonresidents. On the other hand, the drop in the volume of share issues by Israeli companies abroad continued and total investment in the secondary market, particularly on the Tel Aviv Stock Exchange, dropped sharply.

In 2006 the slowdown continued in the volume of issues abroad by Israeli companies, paralleling the drop in initial offerings of technology companies in the US.

This year, the volume of share issues abroad by Israeli companies continued to decline and reached a negligible level[35] (after deducting the issues of a large Israeli company amounting to $5.5 billion in shares and $2.6 billion in bonds). The considerable slowdown in the volume of issues is consistent with the drop in initial offerings of technology companies in the US[36] (Figure 7.12). The weakness in the primary market is the result of two factors: a) strict accounting standards in the US (Sarbanes-Oxley) which led to increased demands on public companies and the reduced attractiveness to Israeli companies due to the high costs involved; and b) continued weakness in the share market (NASDAQ) which is a main target for the issues of high-tech companies. These external factors led some companies to issue on smaller exchanges (AIM and OPAX).

Figure 7.12
Technology Share Issues in US and of Israeli Shares Abroad, 1998-2006 (excl. Issues of Pharmaceutical Companies)



SOURCE: Based on direct reports of issuing companies and Bloomberg.

[34] The UN measure, which ranks countries according to volume of direct investment (according to the measurement of the ratio between the country's proportion of worldwide incoming direct investment flows and its share of global domestic product), shows that in 2005 (a three-year moving average) Israel's ranking improved (a decline from 63rd to 85th place) in contrast to the increase among the developing peer group countries (from 50 to 57).

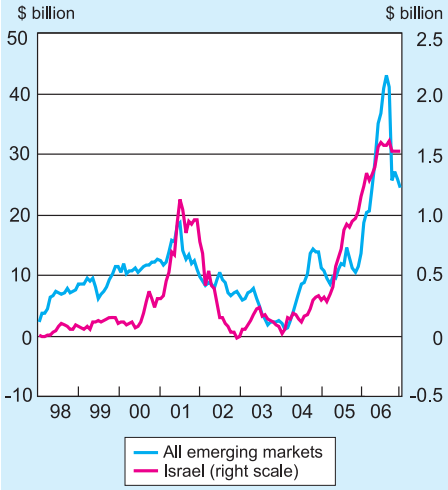
[35] This figure does not include issues of semi-Israeli companies. These are companies that are viewed as Israeli companies or connected to Israel but according to the National Account definitions are considered foreign companies. These issues totaled about $2.7 billion this year, which is more than double their level in the previous year.

[36] The slowdown in the primary market encouraged the trend in mergers and acquisitions which is a substitute for issuing shares.

This year, nonresidents sold shares from their portfolio on the Tel Aviv Stock Exchange ($0.15 billion) as compared to a record level of purchase last year ($2.1 billion) (Figure 7.9). Nonresidents have been active on a large scale on the Tel Aviv Stock Exchange since the end of 2004 and their share of "floating" shares stood at 13.5 percent at the end of 2006. Their activity is concentrated in shares with high liquidity. Thus, 86 percent of their total stock portfolio at the end of 2006, which is estimated at about $10.5 billion, is invested in individual shares that are included in the Maof Index and 60 percent of the portfolio is held by equity and index funds from emerging countries.

Investment in Israel is influenced first and foremost by global trends in capital flows to emerging economies. A long-term analysis (Figure 7.13) shows the correlation between investment by foreign investors in Israeli shares and total investment in shares in emerging economies.[37] However, this year, as a result of domestic factors, the influence of global trends was less pronounced. Thus, at the beginning of the year, investment in Israel was at a relatively low level due to negative local geopolitical factors. In addition, the massive outflow of capital in May and June as a result of the fear of a slowdown in the emerging markets took place on a smaller scale in Israel than for the emerging economies as a whole. This was the result of the relatively low level of investment at the beginning of the year

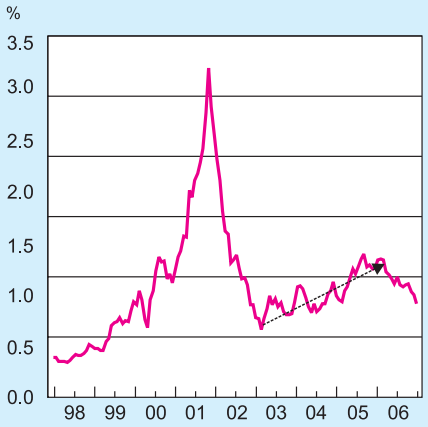
Figure 7.13
Investment of Funds Specializing in Emerging Markets, in Israel and in All Emerging Markets, January 1998 to September 2006



SOURCE: Emerging Portfolio Fund Research.

This year, as a result of domestic factors, the effect on the economy of global trends in financial capital flows was less pronounced.

Figure 7.14
Proportion of Israeli Shares (In Israel and Abroad) out of Total Investment Balance of Funds Specializing in Emerging Market Economies, 1998-2006



SOURCE: Emerging Portfolio Fund Research.

[37] 550 equity funds that specialize in investment in shares in emerging markets and which own assets valued at about $220 billion. The total investment by these funds in Israeli shares stood at $3 billion at the end of 2006. For the sake of comparison, this is one third of the portfolio of financial investment of foreign residents in the shares on the Tel Aviv Stock Exchange.

and the assessment that Israeli shares were relatively stable and could be characterized as defensive.[38]

The Israeli economy's ability to compete for financial investment and its relative attractiveness are reflected in the proportion of the total investment in Israel by equity funds that specialize in emerging economies within these funds' total investment in the shares of emerging economies (Figure 7.14). In the long term, the proportion of Israeli shares in the total asset portfolio of equity funds is about one percent. It can be seen that in 2004, an upward trend began in the relative attractiveness of Israeli shares, simultaneous with the improvement in the basic variables of the economy, and that this trend was cut short in early 2006 as a result of local geopolitical events.

The investment by nonresidents in bonds traded on the Tel Aviv Stock Exchange totaled a record $2.2 billion this year as compared to a negligible level of investment in previous years. Most of this investment was concentrated in the last quarter of the year with the initiation of activity by nonresidents as market makers in government bonds. (For further discussion of this topic, see Chapter 4.3 Financial Markets and Box 1 there.) As a result, the proportion of the holdings of nonresidents in shekel-denominated bonds (including *makam*) rose from 1.3 percent prior to the reform to 3.7 percent at the end of the year. In the long term, higher rates of holdings can be expected since the average rate of holdings of government bonds by foreigners in emerging markets, most of which have foreign market makers in their bond markets, stands at about 13 percent.[39]

Other investment

Other investment by nonresidents—composed of shekel and foreign currency deposits in banks in Israel and the granting of direct and commercial credit—totaled about $1.8 billion this year as compared to $0.6 billion last year. The increase was mainly in nonresidents' deposits, which totaled $1.5 billion this year as compared to $0.3 billion last year. This was the result of the attractiveness of bank deposits relative to the investment in bonds, in view of the uncertainty regarding future yields on foreign bonds.

c. Foreign investment by Israeli residents

Investment by Israeli residents abroad (including investment by the government and the Bank of Israel), which includes shares, bonds, real estate, credit, deposits and foreign exchange reserves, reached a record level of some $32.1 billion as compared to $18.5 billion last year (Figure 7.2). The main part of the increase was the result of growth in direct investment abroad and in deposits of the private sector abroad

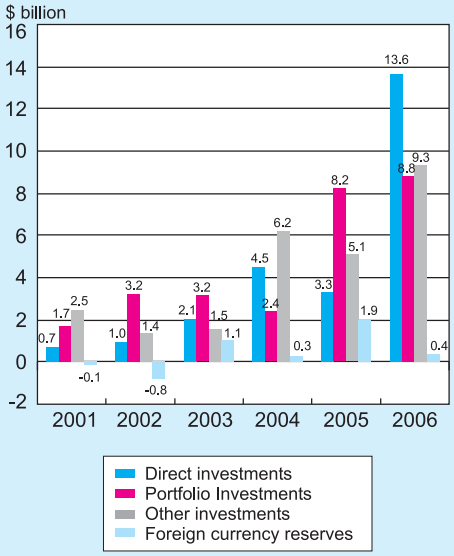
[38] The assessment of the Israeli share market as defensive was shared by most foreign banks. This implies that when share indices in emerging markets increase by a certain rate, the Israeli index increases by a lower rate. This is also true for a decrease in share prices.

[39] IMF Global Financial Stability Report, April 2006.

while the investment in foreign bonds declined.

The changes in the volume of portfolio and other investment by Israeli residents abroad, as well as the mix of alternative investments abroad, were determined this year primarily by global developments. Some of them tended to increase the volume of investment by the business sector abroad, such as the expansion of trade which worked to increase export revenues, the narrowing of the interest rate differential between Israel and abroad and the weakening of the dollar which encouraged the redemption of credit. These effects enlarged the business sector's sources of foreign currency and the banks' surplus of sources, which were channeled to deposits and investment in foreign bonds. On the other hand, the sharp declines in the share indices in the emerging markets during May-June acted to slow the rate of investment by institutional investors aboard and to encourage selling by households. The mix of foreign investment by Israeli residents was influenced by the lack of certainty regarding future yields abroad and the low levels of long-term yields there. As alternative channels to the investment in bonds, banks and the business sector preferred deposits and institutional investors preferred shares.

Figure 7.15
Residents' Investments Abroad by Investment Category, 2001–2006



SOURCE: Central Bureau of Statistics.

The increase in export revenues, the narrowing of the interest rate differential between Israel and abroad, and the weakening of the dollar acted to increase the extent of business sector investment abroad.

Direct investment abroad

Foreign direct investment by Israeli residents totaled $13.6 billion in 2006 as compared to about $3.3 billion last year. If the transactions of a large Israeli company are excluded, then direct investment remained unchanged this year. As in past years, most of the foreign direct investment was carried out by high-tech companies. This year the investment by Israeli companies in real estate[40] continued ($0.5 billion as compared to $0.35 billion last year).

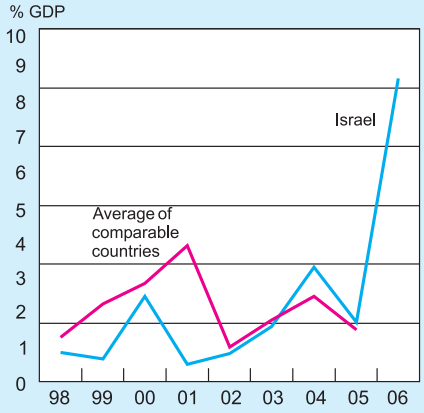
Foreign direct investment by the business sector was encouraged by the globalization process whereby Israeli companies used liquidity surpluses in order to expand and purchase marketing and production facilities abroad. A comparison

[40] According to the industry classification of the investing company since companies in the real estate industry do not generally invest in non-real estate activity. For a characterization of this activity, see the parallel chapter in the previous Bank of Israel Annual Report.

Foreign direct investment by the business sector was encouraged by the globalization process, as were the direct investments by multinational companies from developing countries.

of the volume of direct investment in terms of percentage of GDP relative to the comparison countries[41] (Figure 7.16) shows that on average (1998–2005) the rate of direct investment abroad, although slightly lower than that in the peer group countries (about 1.6 percent compared with 2.5 percent) has been steadily increasing since 2001. This development is part of the trend in direct investment by multinational companies from the developing countries, which in recent years have become global players.[42] Direct investment is essential in order to cope with competition in the global market since it increases access to essential resources for global competition, such as production facilities, financial markets and foreign capital, as well as technology and labor.

Figure 7.16
Direct Investments of Israel and Comparable Countries Abroad, 1998-2006



SOURCE: Based on data from World Bank Indicators and UNCTAD.

Portfolio investment

Institutional investors reduced the flow of their investment into foreign bonds, against the background of the high degree of uncertainty regarding future yields.

Portfolio investment abroad totaled a record $8.8 billion this year as compared to $8.2 billion last year. In contrast to last year, the majority of the investment was in shares ($5.1 billion) and most of that was by institutional investors. Meanwhile, investment in bonds totaled only about $3.6 billion (as compared to $4.6 billion last year), most of which was by the banks and the business sector. Institutional investors reduced the flow of their investments in bonds against the background of uncertainty in the markets regarding future bond yields and, in their view, their low yields.

Institutional investors—provident funds, pension funds and insurance companies—are carrying out a long-term strategy for the global diversification of their portfolios, which became possible with the equalization of tax rates on local and foreign securities starting from 2005 and with the regulatory changes in the industry.[43] As a result of these reforms, the proportion of investment in foreign assets by institutional investors within their total assets has risen during the last two years and stood at 8.5 percent at the end of 2006, as compared to 2.5 percent prior to the reform (see Figure 4.11 in the Chapter on the Financial System). Nonetheless, this proportion is lower than

[41] See footnote 17.

[42] FDI from developing and transition economies: implications for development. World Investment Report 2006.

[43] The permission given to veteran pension funds to invest abroad (since the end of 2005) and the purchase of the provident funds by the insurance companies. The insurance companies had more extensive experience in activity abroad since they have been investing there since 2001.

the proportion of foreign investment by institutional investors[44] in similar countries (25 percent). Foreign investment by institutional investors totaled about $3.3 billion this year, which is similar to its level last year. However, in contrast to last year, most of the investment was concentrated in shares and alternative investments.[45] The rate of investment was not uniform over the course of the year and was affected by developments in the financial markets. The appreciation since April, which caused losses to institutional investors in shekel terms, and the declines in the emerging markets in May and June led to a slowing of the pace of investment during the third quarter though the pace was renewed in the last quarter.

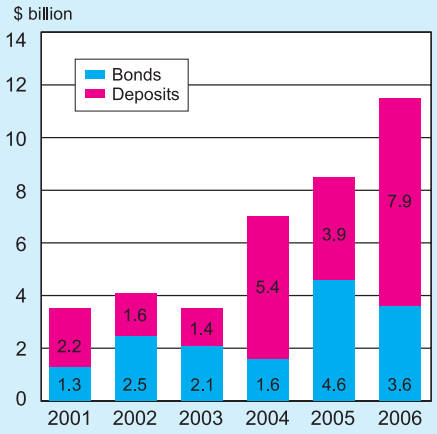
Falling share prices in the emerging markets in May-June caused a slowdown in the pace of investment of institutionals and a process of redemptions from mutual funds.

Households invest in foreign shares primarily through mutual funds and basket exchange-traded funds (ETFs).[46] This year, they invested about $1.3 billion in foreign shares, which was similar to the amount invested last year. The activity in this investment channel was not uniform over the year and was also influenced by the trends in the financial markets. Thus, the drop in prices in the share markets of the emerging countries in May-June and the strengthening of the shekel initiated a process of redemption of mutual funds that continued until the end of the year.

Other investment

The other investment of the private sector (excluding the government Query: isn't the government part of the public sector? Why is it mentioned here?) totaled about $9.7 billion as compared to $6.4 billion last year and was accompanied by a change in composition. The total credit to nonresidents declined while deposits abroad increased significantly (Figure 7.17). Most of the deposits (about $6.3 billion) were made by the banks from their surpluses in sources of foreign currency. These surpluses were the result of: deposits by the business sector due to the increase in export revenues; the deposits of households and the redemption of credit by the business sector due to the low level

Figure 7.17
Investment Flows of Private Sector in Bonds and Deposits Abroad,[a] 2001–2006



[a] Bonds are a component of 'investment in portfolio securities', while deposits are a component of 'other investment.'
SOURCE: Based on company and bank reports.

Banks invested abroad their surplus foreign currency sources that resulted from a rise in export revenues, deposits, and repayment of credit.

[44] For a more detailed discussion on the adjustment of the asset portfolios of institutional investors, see Box 3 in Chapter 4.

[45] Hedge funds, private equity funds, structured instruments and other non-traded financial instruments. This development is consistent with the worldwide trend and is the result of the increased exposure of institutional investors to global markets.

[46] Sixty percent of the total investment in ETFs on foreign share indices is held by households. Most of the holdings (about 63 percent) are ETFs tracking the share indices of stock exchanges in developed countries.

of the exchange rate and the narrowing of the interest rate spread; and the deposits of nonresidents. The deposits of the business sector abroad grew this year as a result of the deposit of revenues from the sale of a large Israeli company abroad.

d. Financing of the deficits in the trade account and the income account and the main developments in the external debt

1. Financing of the deficit

The surplus in sources of financing over financing needs allowed the economy to increase its net surplus of debt instruments abroad.

The financing needs[47] of the economy were low this year ($0.7 billion) thanks to the significant reduction in the deficit in the goods, services and income (factors of production) account which went down to $0.6 billion. The sources of non-debt financing available to the economy are current transfers, capital transfers and the net investment surplus in equity instruments (the surplus of direct and financial investment by nonresidents in Israel over foreign investment by Israeli residents). The current and capital transfers to the economy totaled $8.4 billion during this period and the net investment surplus of nonresidents totaled $0.8 billion. Thus, the total surplus of non-debt sources over financing needs totaled $8.4 billion during the surveyed period. This surplus enabled the economy to increase its net surplus of debt instruments (loans and deposits) abroad by $8 billion. Together with the increase of $0.4 billion in the foreign exchange reserves and the effect on the value of assets of exchange rate differentials and capital gains, the foreign assets surplus rose by $10.5 billion.

2. Developments in the external debt

The foreign asset (debt instrument) surplus continued to rise, for the fifth year in succession, and by the end of the year had reached $31.7 billion.

The gross external debt totaled approximately $83 billion at the end of 2006. Its rate of increase was moderate relative to the increase in assets (debt instruments) abroad, such that the foreign asset (debt instrument) surplus continued to increase for the fifth year in a row and totaled $31.7 billion at the end of the year.[48]

The short-term asset (debt instrument) surplus totaled some $47 billion at the end of 2006, which represents an increase of some $8.4 billion relative to the end of 2005. This was primarily the result of the increase in corporate and bank deposits abroad.

The proportion of tradable debt in the total gross external debt increased in 2006 to 34 percent. This is primarily the result of the increase in the issue of bonds by the business sector and the increase in the proportion of tradable bonds issued by the government. This development is an expression of the Israeli economy's continuing

[47] The deficit requiring financing by the economy is the deficit in the goods, services and income accounts less statistical discrepancies. These discrepancies reflect measurement error both in the current account and the financial account.

[48] It should be borne in mind, however, that in measuring total liabilities and assets—capital instruments as well as debt instruments (the international investment position, IIP)—Israel has a liabilities surplus. This position is also improving, and the surplus fell to $13.3 billion at the end of 2006.

process of integration within global financial markets and is evidence of the ability of the various sectors to raise capital abroad.

The business sector's gross amount of external debt stood at $33.5 billion at the end of 2006, which represents an increase of about $2 billion compared to 2005. The government is the main borrower in the public sector and the proportion of its debt in the economy's total gross debt was 40 percent this year. During 2006, the government raised funds through the issue of bonds (both traded and non-traded) abroad in the amount of $2.7 billion and redeemed a total of $3.1 billion in bonds. Government interest payments totaled about $1.5 billion in 2006. Nonresidents' (net) purchase of shekel-denominated government bonds totaled about $2.2 billion in 2006, which was primarily the result of the market makers reform. The foreign exchange reserves totaled $29 billion at the end of 2006, which represents an increase of about $1 billion during the year.

The private non-banking sector's gross external debt totaled $24.5 billion at the end of 2006, which represents an increase of about 20 percent relative to the end of 2005. This is primarily the result of the issue of bonds abroad by a large company.

Table 7.7
Israel's Gross and Net External Debt

(balance, $ billion)

	31.12.03	31.12.04	31.12.05	31.12.06
Israel's gross external debt				
1. Public sector	29.9	31.3	31.4	33.5
2. Non-bank private sector	15.6	19.7	20.0	24.5
3. Banking system	24.7	24.0	23.2	25.0
4. Total gross external debt (1+2+3)	70.2	74.9	74.6	82.9
Assets abroad (debt instruments and the Bank of Israel's foreign exchange reserves)				
5. Public sector	28.5	29.3	29.0	29.7
6. Non-bank private sector	30.6	35.1	40.8	50.1
7. Banking system	17.8	21.7	26.0	34.8
8. Total assets abroad (5+6+7)	76.8	86.1	95.8	114.7
Net external debt				
9. Public sector (1-5)	1.4	2.0	2.4	3.7
10. Non-bank private sector (2-6)	-15.0	-15.4	-20.8	-25.7
11. Banking system (3-7)	7.0	2.3	-2.8	-9.8
12. Net external debt (4-8)	**-6.6**	**-11.1**	**-21.2**	**-31.7**

SOURCE: Central Bureau of Statistics.