Bank of Israel
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Abstract

OVERVIEW AND POLICY

Israel's external and foreign-exchange activity in 2004 reflects a trend toward stabilization and improvement in the operation of the NIS/foreign-currency market and in the balance of payments, as well as a trend toward financial stability of the economy connected to these areas. The improvement, starting in 2003 with clear signs that the deterioration in the economy during 2001 and 2002 had been halted—grew stronger and consolidated itself during the year. The improvement is a consequence of the continuation and strengthening of developments that took place in the basic variables and the background conditions of the economy, against the backdrop of accelerated activity in the global economy: emergence from the slowdown and the transition to export-oriented growth while meeting the objective of price stability and a certain reduction in the level of unemployment in the economy, even though the economy has still not realized its full growth potential; reinstatement of the credibility of macroeconomic policy—which had been eroded in 2002 and already showed signs of recovery in 2003—thanks to cautious and prudent policy accompanied by reducing the rate of interest by 6.2 percentage points in the past two years; government policy which followed a stable and coherent track of budgetary discipline, and an accelerated pace of implementation of structural reforms and changes; evidence of recovery in the world economy, as expressed both in the increased tempo of growth and in world trade, including the high-tech industry whose impact on the Israeli economy is considerable, and in positive trends in the global financial markets; the confrontation with the Palestinians which indeed continued, yet its intensity decreased and conditions were created for the renewal of the political process. All these processes were expressed in the stability of the NIS which even appreciated by 1.6 percent relative to the dollar, and stabilized at a low level of exchange-rate risk, even though a certain rising risk trend could be discerned in the last few months of the year.

The current account of the balance of payments showed a surplus of about half a billion dollars—a continuation of the trend that developed in 2003 in contrast to the characteristics of the past decade. This surplus reflects the continuing recovery in the world economy, together with a pronounced growth in the volume of world trade and an acceleration in the level of activity of the Israeli economy which was expressed in a growth in exports at all levels of technological intensity. This surplus was also created against the background of the depreciation in the real exchange rate since 2001, which expresses the market's competitive ability vis-à-vis overseas markets. As opposed to last year, all components of imports grew this year in view of the recovery in the economy.

In the financial account the expanding trend in activity that began last year continued this year, even though the activity level of nonresidents and Israelis is still lower than in 2000, which represents a financial bubble in the world economy.

Nonresident investment grew slightly, with a sharp change in its composition—an abrupt decline in the volume of direct investment and a pronounced growth in the volume of investment in the commercial securities portfolio. The decline in direct investments is conspicuous against the background of the improvement in macroeconomic conditions in Israel and the increased volume of mergers and acquisitions in the world, but it does not appear to reflect a change in the assessment of the attractiveness and the risk of the Israeli economy.

The stability in the NIS/ foreign-currency market was expressed in a moderate volume of capital movement relative to previous years and can be viewed as a consequence of a balance between forces that affected the exchange-rate in opposing directions: short-term factors that operated for most of the year in the direction of weakening the local currency, and long-term factors that acted to strengthen it, following the trends evident in 2003.

The main factors influencing short-term activity were the considerable contraction in the interest-rate differential between the NIS and the dollar—6.2 percentage points during the past two years, a more moderate contraction in the yield differential, and a greater contraction in the effective differentials as a result of the introduction of the tax reform. This year too, short-term forces operated with greater intensity, reflecting changes in world exchange rates, a consequence of global imbalances, changes in global investment patterns that are also affected by these problems, and changes in the perception of risk of the US dollar. The major long-term forces that operated to support the NIS were: nonresident investments that grew slightly in comparison with the previous year—against the background of the world economic recovery in general, and the high-tech sector in particular; continuity and even growth in the current-account surplus; the surplus created in the economy's basic account comprising these movements, as well as the long-term movements of Israeli residents. All these are expressed in the existence of a stable and continuous supply of foreign currency in the market, thereby helping to reduce the sensitivity of the exchange rate to the influences of short-term movements as well as avoiding greater volatility in the exchange rate.

In continuation of the trends that developed during the past year, a further improvement was recorded this year in **financial stability connected to the activity of the economy vis-à-vis abroad and in foreign currency** accompanied by stabilization at a low level of yield and risk. The stability of the markets, including the NIS/foreign-currency market, is a consequence of pursuing a rational and steady process of reducing interest rates—while maintaining a high level of credibility in the public's eyes—to the lowest level in the history of the economy, as well as reducing the interest-rate differential relative to the dollar to a historically low level, together with the lowest level of exchange-rate risk, both in comparative historical terms and in comparative international terms. At the same time, the credit risk of the economy, which reflects the level of risk of the economy from the perspective of the international financial markets, contracted, similar to the trend that characterized other emerging markets, and the financial status of the economy, as measured by the international credit-rating agencies, also stabilized. The ending of tax discrimination, which constitutes the final stage in the process of removing the restraints in the economy vis-à-vis abroad, did not harm the stability of the markets, despite the dire warnings of various entities in the economy that opposed these processes. The improvement in financial stability, in tandem with the process of reducing interest rates while maintaining the low level of risk of the exchange rate and the risk to the country, reflects the influence of a series of long-term variables that underlie the external stability of the economy: the improvement in the economy's basic account; the guarantees arrangement that enables Israel to raise funds on international markets guaranteed by the US administration, and whose exploitation is one of the reasons for the growth in the reserves managed by the Bank of Israel, and which contribute to strengthening the resistance of the economy to external shocks; the net external debt, which since 2002 has become a net asset surplus which amounted to about 12 billion dollars at the end of this year; an improvement in the robustness of the business sector, including ending the exposure of the business sector to exchange-rate risk that in previous years constituted a potentially threat to the stability of the market—because of the fear that the rapid closure of the large gaps that were widespread in those years was liable to increase the fluctuations in the exchange rate.

The resilience and the stability of the markets were put to the test in 2004, a consequence of a significant process of adjustment of the public's asset portfolio, a development that could have been expected against the backdrop of the completion and maturation of three long-term processes being managed in the Israeli economy during the past decade: first—completion of the disinflation process together with the rapid reduction of domestic interest levels and the interest differentials vis-à-vis abroad; second—completion of the process of liberalization during the past year, which allowed Israeli residents full freedom of action, including reallocation of their asset portfolio and increasing their involvement in global markets; and third—as part of the process of removing the restrictions vis-à-vis abroad, the tax discrimination between NIS assets and domestic foreign currency assets had already been removed in 2003, and during the year it already become clear that the tax discrimination between NIS assets and assets abroad would follow suit at the beginning of 2005. The completion of the process of removing the restrictions vis-à-vis abroad—which offers many advantages and constitutes a central pillar of the macroeconomic strategy the country has adopted in striving towards realizing the economy's growth potential—combined with a low -interest rate and a low interest rate differential vis-à-vis abroad, had the effect of creating the potential for realigning the public's asset portfolio by increasing the foreign-currency and assets-abroad components, and creating heavy pressure on the demand for foreign currency. And indeed, in the first part of the year, continuing from 2003, there was evidence of a process of adjustment, especially in the household sector through the acquisition of mutual funds invested abroad. During the year, however, the acquisition of foreign assets diminished and even reached a complete standstill. The moderate level of activity and its lack of persistence can be explained by a long list of factors, at the head of which are global factors: uncertainty regarding global markets, and especially the US capital market which constitutes the major target market for Israeli investors—both households and institutions—against the backdrop of the "twin deficits" of the US economy (the trade deficit and the budget deficit). The major contributing factor was the uncertainty regarding the US bond market—namely, fears about interest rate hikes and long-term yields in the United States—which was meant to be the major channel of the expected adjustment process. The domestic factors that worked toward discouraging overseas investment were expressed by the low domestic exchange-rate risk, as opposed to the increasing risk of investing in dollar assets as a result of the processes mentioned, which together with the positive trends in the domestic capital market, tended to favor it. The major insights that emerge from these developments are that even if all the necessary conditions for significant change in the public's asset portfolio are met, the sufficient conditions were not met this year; the adjustment process in the asset portfolio is not continuous nor even uni-directional. It is affected both by structural factors such as "home bias"—the tendency of domestic bodies to invest less in foreign assets than would be required in terms of an optimal portfolio allocation—and by short-term factors affecting its intensity in a given period, such as expectations regarding global marketing trends in comparison with the domestic market.

Additional aspects of the adjustment of institutional investors and households are connected to two policy issues: the first—in an attempt to encourage competition between the institutional entities and to increase their transparency, the Ministry of Finance publishes their yields monthly. It would appear that this step increases the weight of short-term considerations in the overall considerations affecting the composition of the portfolio, thereby distorting the allocation of an optimal portfolio based on long-term yield and risk levels of the economy vis-à-vis abroad. The second concerns the issue of the centralization of the capital market—households' marginal volume of holdings of exchange-traded funds (ETFs), which represent an investment in foreign shares indices, and which, in 2004, enjoyed a tax advantage as opposed to parallel investment mechanisms such as mutual funds, reflect the problems of conflicts of interest and a lack of unbiased advice given by the banks, which manage most of the mutual funds.

Another major insight that emerges from the development of the adjustment process this year, concerns the **level of impact of the interest-rate differential on the stability of the exchange rate**, against the background of widespread assessments by the public of the need to avoid contracting the interest-rate differential to a level that threatens the stability of the markets, and rather to preserve a certain "floor" of interest-rate differentials. Developments this year show that a fixed "floor" does not exist indefinitely, and that an interest-rate differential that is consistent with the stability of the market, changes according to changes in the background conditions and the domestic risk level—relative to the risks of alternative global assets. The continual improvement in these areas enabled the process of contracting the interest-rate differential to continue, as well as reducing their role as part of the overall forces affecting the exchange rate, and particularly the long-term forces that supported the stability of the NIS. As opposed to this, the impact of global processes has intensified in recent years, an expression of increasing integration of the domestic and the global financial markets, evidence of which can be found in the reduction of Israel's country risk in conjunction with the reduction of worldwide risks—with the ending of the Iraq war—and the diversion of capital flows to emerging economies, including Israel, and thus to increasing the correlation between changes in the exchange rate worldwide and changes in the NIS exchange rate during 2004. However, the low level of interest-rate differentials increases the sensitivity of the exchange rate to changes in the background conditions of the economy, especially to fundamental deviations from the accepted criteria in developed countries regarding the macroeconomic management of the economy, but also to sharp changes in world exchange rates, interest rates, and asset prices, as a possible consequence of the current global imbalance.

In 2004 **the process of enhancing the NIS/foreign-currency market** continued, expressed, *inter alia*, in the issuance of new financial instruments, against the backdrop of the contracting supply of foreign-currency assets as a result of the expiry of dollar-indexed government bonds (*Gilboa)*, as well as the issuance of ETFs of a range of global assets. It does, however, appear that the expansion of this market, which is the deepest and most liquid of Israel's financial markets, has been checked, after a gradual process of improvement and deepening in the past decade against the backdrop of the liberalization in foreign exchange control, flexibility in the exchange-rate regime, and the increased activity of foreign entities. The stability in the volume of currency conversions, and the decline referred to in the exchange-rate risk—even though an increase was recorded in these toward the end of the year—call into question the long-term path of the development of this market. While these factors may reflect the completion of the development process, they may also reflect structural problems, such as the level of development and the depth of the domestic capital market and discrepancies in trading patterns between domestic and foreign banks. These are characterized by a high degree of centralization—both regarding the number of active bodies as well as the limited number of shares and bonds with which they deal—by heterogeneity in their activities in the foreign-currency market and their considerable influence on the share market at certain periods. Particularly notable is the low level of **exchange-rate risk**, both by historical and by international standards, in view of assessments regarding its expected increase as a result of the long-term structural changes mentioned above. The future trend of this variable is highly significant in the context of monetary policy, because its decline offset the effect on the exchange rate of the marked interest rate cuts made during the year.

Against the backdrop of the growing openness of the economy and its integration in global economics, its greater sensitivity to external shocks, and the fact that it is subject to scrutiny by the global financial markets, special importance is attributed to responsible and prudent macroeconomic policy in accordance with the standards currently prevailing in developed economies, in addition to creating the conditions to enable the continued development and refinement of the market. In this context there is a need to remove the last remaining obstacle that prevents the economy from operating with a completely freely floating exchange rate and under conditions of full liberalization—**the exchange-rate band**. This band has widened over the past decade, but even though it is no longer effective, it still limits the potential range of mobility of the exchange rate, and embodies a potential distortion in the perception of risk by market players. Its annulment at a time that it is no longer effective and the transition to a completely floating exchange rate regime will prevent the generation of distortions of this kind and will enable the exchange rate to operate as a shock absorber, as is the norm in developed countries.

The private sector's exchange-rate risk management is crucial for the process of market development in an era of transition to a floating exchange rate. In the long term, as a result of the convergence of domestic inflation rates in recent years to those in developed countries, the rate is expected to vary without a clear-cut trend—as opposed to the constant and ongoing depreciation that prevailed until the late 1990s. In this situation, the allocation of responsibility for exchange-rate risk between the central bank and the private sector, requires the former to operate toward attaining price stability, which should serve to reduce the long-term volatility of the exchange rate, and the latter to manage risk thoughtfully and systematically in order to minimize the effect of the volatility on their business results. Despite the rapid development of the derivatives market, the increased volume of activity, and the development of a variety of instruments for different players and needs, the intensity with which the business sector uses hedging instruments is still low relative to the extent of its activity and the exposure to exchange-rate risk. One of the main problems precluding greater use of instruments intended to hedge against risk, is the way they are currently presented in financial statements, which constitutes a negative incentive for using them. The authorities thus need to take the initiative to regulate matters in order to bring about a more efficient distribution of risks, thereby contributing to the greater stability of both the business sector and the market as a whole.

Another phenomenon attesting to the public's lack of internalization of the end of the process of disinflation and the transition to a floating exchange rate that is expected to fluctuate in both directions without a clear trend, is that of "**dollarization**". Dollarization is expressed in the large component in the public's asset portfolio of assets linked to or stated in foreign currency, in a large exposure to appreciation in the balance of assets and households' foreign currency liabilities, and in a complete series of linkage arrangements and dollar payments. It can be assumed that in the long term the weight of the domestic dollar assets held with the motive of linkage to the exchange rate will decline, whereas the weight of the assets abroad, held for considerations of dispersal will increase. A contraction in linkage arrangements and dollar payments is likely to take place as an ongoing process, which the various authorities have a role in promoting, *inter alia* by legislative means. Thus, for example, the arrangement for determining the price of electricity in the economy embodies a linkage between the price of electricity and changes in the exchange rate––beyond that which is justified by the price of the inputs. Importance is attributed to diminishing dollarization in the economy in the context of consolidating price stability and weakening the transmission from the exchange rate to inflation, since in the current circumstances it would appear that a sharp and rapid devaluation of the NIS, as a result of an external shock, is the main factor endangering the price stability that has taken root in the economy.

In order to develop policy aimed at attaining the stability of prices and of the financial markets it is necessary to analyze the conditions for stability —based *inter alia* on past experience—as well as the factors that create and increase vulnerability and the processes that undermine stability. Constant monitoring is required in order to identify such processes as early as possible, while distinguishing between temporary negative development and the onset of a damaging process. Special importance is attributed to the sectoral analysis of economic activity—identifying the behavior patterns of the various sectors, chief among them the major financial players and households, in times of calm and in times of crisis, and monitoring changes in their activity. The basis for monitoring and analysis of this kind is comprehensive, detailed, and up-to-date information. In the past few years, concurrent with the liberalization process, the **Foreign Exchange Activity Department** has constructed extensive and detailed information systems on economic activity vis-à-vis abroad and in foreign currency. These systems make it possible to analyze monetary policy needs on an ongoing basis, to track the stability of the economy, and to identify focal points of vulnerability and processes in which stability is undermined. The information collected is processed within the Department and published regularly with a minimal lag, with the aim of improving the transparency, the quality, and the availability of the information in the hands of the players in the financial markets. The Department also publishes various reviews, press releases, and research studies in the area of its activity, and organizes meetings to create channels of direct communication between it and the various market players. This is done in the realization that transparency in the markets contributes to making them more perfect, thereby increasing financial stability.

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This report contains three parts. The first analyzes market developments within the accepted international framework of the **balance of payments**, that is to say, economic activity vis-à-vis nonresidents in foreign and local currency, and includes the movements in both the current account and the financial account of the balance of payments and the asset surpluses and liabilities vis-à-vis abroad, including the external debt. The unique nature of the Israeli economy and the prominent part played by the exchange rate in domestic activity requires a separate analysis enabling all the forces acting on the exchange rate to be identified. This issue is dealt with in the second part—**NIS/foreign-currency activity**—the activity of Israeli residents from the various sectors in foreign currency assets and liabilities (denominated and linked, vis-à-vis nonresidents and between the sectors themselves) and the activities of nonresidents solely in NIS assets and liabilities (including NIS/foreign-currency forward transactions). The differences between the analytical frameworks are presented in the Department's Internet site.

The liberalization process has exposed the Israeli economy to international capital movements and has made it more sensitive to external financial risks. It is thus necessary to continually monitor its external financial stability. **Financial stability** is analyzed in the third part of the report, in the context of activity in the NIS/foreign-exchange market and vis-à-vis abroad.