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Foreign Exchange Activity Department

Assets and Liabilities Unit

Israel's Financial Account, 1998 to 2005

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Summary

In the years from 1998 to 2005 Israel’s financial activity vis-à-vis abroad underwent significant changes. Israelis invested $ 68 billion abroad, and nonresidents invested $ 57 billion in Israel. Several developments contributed to this high level of activity: liberalization of the foreign exchange market which started in 1998 and which offered new possibilities for Israelis to raise capital abroad and to invest abroad; increased exposure of the economy to external factors, in keeping with increasing globalization that was expressed *inter alia* by increased capital flows to and from emerging markets; tax reform that reduced discrimination and distortion in the taxation of financial assets contributing to increased investment abroad by Israelis. In addition to the above, Israeli industry underwent considerable structural changes, with the expansion of the high-tech sector to a leading position in the economy.

Inward and outward capital flows showed more of an increase than did Israel’s GDP; nonresident investment in equity and foreign direct investment in Israel rose rapidly; the proportion of tradable investment in the economy also grew to a certain extent; all of which contributed to a change in the composition of Israel’s assets and liabilities portfolio.

The main effect of the Israeli economy's increased external exposure was seen in the financial activity of the private nonbanking sector, which raised capital in financial markets abroad and became less dependent on the traditional financial intermediaries such as the Israeli government and domestic banks. As a result, the government’s and the domestic banks’ shares in Israel’s total external liabilities declined, while the share of the private nonbanking sector rose. The nonbanking sector's external assets increased as well, bringing the economy from a state of a net external borrower of some $ 15 billion at the end of 1997 to having a net asset surplus (debt instruments) of $ 23 billion at the end of 2005.

Objective

The aim of this paper is to examine developments in Israel's financial account in the period following liberalization of the foreign exchange market. Changes in balances and flows, by type of investment and broken down by (resident) economic sector are discussed here, in analyzing developments in Israel's financial account from the second half of 1998 to the end of 2005 (the period under review).

Introduction

Since 1998, Israel's central bank, the Bank of Israel publishes quarterly data on the state of the country's external assets and liabilities, in a report called the International Investment Position (IIP), which presents the relationship between the balance of assets and liabilities of an economy and the flow of capital vis-à-vis abroad. The International Monetary Fund requires all its member countries to submit such a report in accordance with its Special Data Dissemination Standard (SDDS). Israel's IIP presents resident investment abroad and nonresident investment in Israel in terms of balances ("positions" in IIP terminology) at the beginning and at the end of each quarter and presents the components leading to the changes in these balances during the quarter. Changes in investment can be attributed to several factors: net flows ("transactions"), i.e., investment *less* disinvestment; "price changes"; "exchange rate changes", as a result of changes in the exchange rate between the dollar and other currencies since the data is presented in dollars; and "other adjustments". Net flows express the financing of the current account of the balance of payments and the balances express the economy's total external exposure.

The financial account (IIP) is divided into two parts: the assets side deals with resident investment abroad while the liabilities side shows nonresident investment in Israel. External liabilities represent total nonresident claims on the Israeli economy including—in addition to debt instruments which are in effect Israel's external debt (comprising credit, deposits and bonds)—equity liabilities (investment in shares). External assets are in effect the Israeli economy's total claims on the rest of the world.

We analyze the transactions and positions of Israel's financial account over the period reviewed by two major breakdowns: type of investment, that is direct investment, portfolio investment (equity and tradable bonds) and other investment (credit and deposits); and major economic (resident) sector, that is the public sector, the private nonbanking sector and the banking sector.

Main developments in the financial account

Background conditions

Since 1998 there have been many changes in Israel and abroad that have affected both resident investment abroad and nonresident investment in Israel. The liberalization of the foreign exchange market which began on May 14, 1998 with the change in foreign currency supervision, removed limits on capital movements and allowed Israelis almost complete freedom of action in their shekel and foreign currency dealings with nonresidents[1]. The liberalization process in the foreign exchange market was completed in January 2003 with the removal of the last remaining restrictions on institutional investors, allowing them to invest freely in assets denominated in foreign

[1] Despite the declaration of foreign exchange liberalization in 1998, the process of liberalization had been ongoing since the 1980s. Simultaneous with the removal of restrictions, in order to allow continuous and reliable tracking of inward and outward capital flows, the Department of Foreign Exchange Activity in the Bank of Israel had its reporting requirements expanded. The expanded reporting makes it possible to efficiently compile Israel's financial account.

currency both in Israel and abroad. This process was part of a strategy to increase the openness of the economy to allow its full growth potential[2]. The globalization process grew and with it, nonresident investment in emerging markets. At the same time, the Israeli economy became more integrated with the world economy, opening up further possibilities of international capital flows. Israeli industry underwent considerable structural changes, with the expansion of the high-tech sector to a leading position in the economy. When the January 2005 tax reform (after a series of previous tax reforms) came into effect it ended the discrimination between financial activity overseas in relation to that in Israel, and this led to a more efficient allocation of the public's portfolio and an improvement in the functioning of the financial markets. As a result, the economy's financial openness increased, enabling the economy to approach its full growth potential, benefiting from closer integration with the world financial markets in the field of capital movements. This could be seen in several ways: expanded foreign investment in the economy, further activity of foreign financial institutions, and the diversification of the public's assets and liabilities portfolio abroad as they adjusted to the changing conditions.

Liberalization of the market created a more favorable environment for capital flows into and out of the economy, and together with globalization, created favorable conditions for increasing Israel's financial account on both the assets and liabilities sides. The private nonbanking sector saw a **considerable expansion of its activities**, both on the assets and liabilities sides.

Below we examine the developments in the financial account; first on the assets side (resident investment abroad) and then on the liabilities side (nonresident investment in Israel).

Assets side: Resident investment abroad

Israel's balance of external assets expresses the total balance of resident investment abroad or the total of the world's liabilities to the Israeli economy. Israel's asset balance grew by 160 percent in the period reviewed. Growth was seen in each of the investment components in the economy's assets abroad, with the largest increase in other investment (deposits and credit) followed by the increases in portfolio investment and direct investment (Table 1).

[2] See Ozer B., Reiss S. and Y. Soffer (January 2006), Israel's Financial Account Liberalization, Banking Quarterly 157 (*published in Hebrew*).

Table 1: Israel's External Assets and Liabilities (IIP) by Investment Type
($ billion)

	Balance 30.6.98	Balance 31.12.05	Nominal Change	Cumulative Flows
Assets	**47**	**123**	**76**	**68**
Direct investment	5	21	17	16
Portfolio investment	3	26	23	22
Other investment	18	47	29	25
Reserve assets	21	28	7	5
Liabilities	**78**	**153**	**75**	**57**
Direct investment	10	37	26	26
Portfolio investment	28	66	39	22
Other investment	40	50	10	9
Net liabilities	**31**	**30**	**-1**	**-11**

Source: Bank of Israel.

Analyzing the investment flows shows that Israelis invested a net $ 68 billion abroad in the period reviewed: of which 23 percent was in direct investment, 33 percent in portfolio investment, 36 percent in other investment and 8 percent in reserve assets[3]. The asset component that registered the greatest growth was other investment (net flow of $ 25 billion), comprising deposits and credit. Israelis deposited $ 18 billion in banks abroad and extended loans of $ 8 billion to nonresidents, half of which supplier's credit. The growth in deposits in banks overseas was split between banks in Israel, that deposited some $ 11 billion in banks abroad, and the rest: the business sector and households. The rise in deposits of banks in Israel in banks abroad stemmed from the surplus liquidity in foreign exchange of resident banks, as a result of which banks' total sources in foreign currency (resident and nonresident deposits) was greater than their uses of foreign currency (foreign exchange credit).

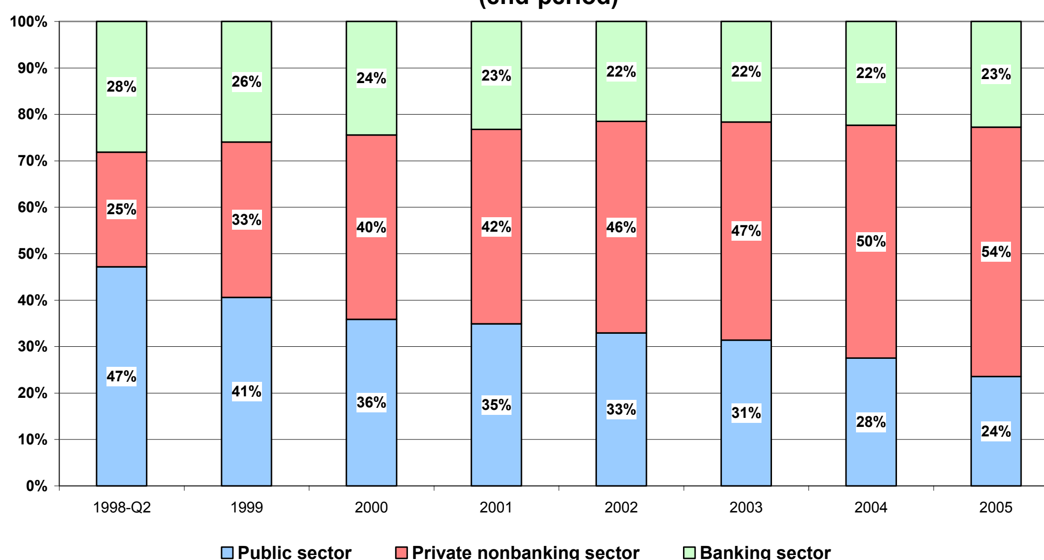
The growth in deposits abroad of the business sector and households stemmed from the process of liberalization in foreign exchange—the removal of restrictions on the transfer of money abroad—as well as the expanded activity of Israeli companies abroad, some of which raised funds abroad (through bonds and shares) and deposited a portion of the receipts in banks abroad; some Israeli companies preferred to make deposits in banks abroad in light of the exemption of tax on income sourced overseas (until the end of 2002) as well as the higher yields offered them by foreign banks. All of these factors boosted the level of competition in the market for deposits, particularly for the business sector[4].

The growth in investment abroad was seen in both portfolio and direct investment. The flow of portfolio investment totaled $ 22 billion of which $ 15 billion was in bonds and the rest in shares. The flow of direct investment totaled $ 16 billion and this was split between investment in subsidiaries (60 percent) and shareholder loans (40 percent).

[3] Mostly foreign exchange reserves at the Bank of Israel.
[4] Schreiber, B.Z. and A. Grossberg (November 2005), Speculative Activity of Israelis in Foreign Currency – in Credit and Deposits, Bank of Israel Survey 78 (*published in Hebrew*).

As a result of the positive investment flows described above, the investment balances all showed changes in the period reviewed: balance of other investment grew by $ 29 billion (160 percent); the portfolio investment balance which was low at the start of the period reviewed grew eightfold by $ 23 billion; while the balance of direct investment, which was also low at the start of the period, grew threefold.

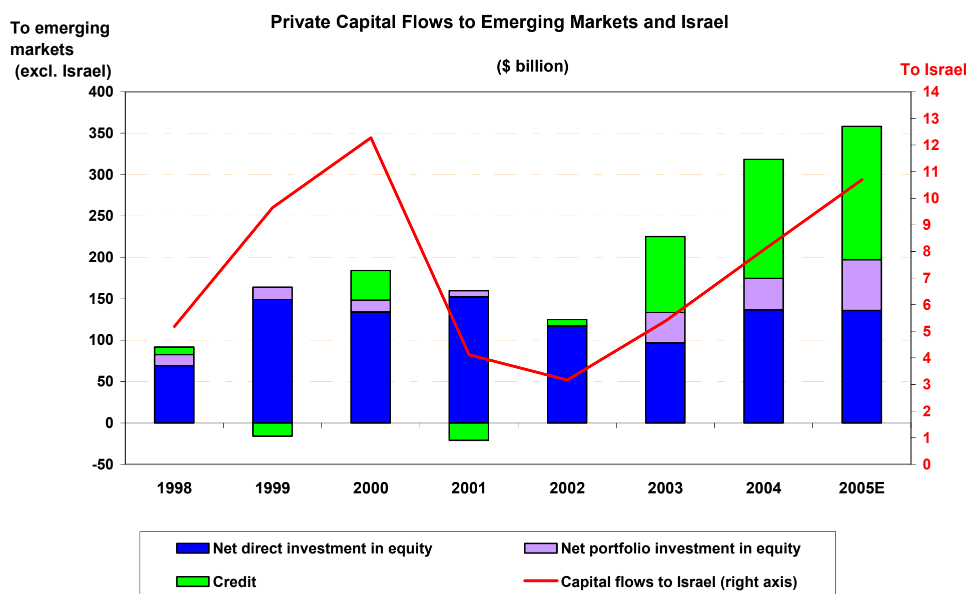
The background factors described above—liberalization of the foreign exchange market, globalization in international capital movements, tax reform and the opening up of the economy financially (and in real terms)—contributed to the economy's expanded activity vis-à-vis abroad, bringing about considerable growth in investment flows leading to high investment balances. As a result, the composition of the balance of assets abroad changed: the share of the private nonbanking sector reached 54 percent of assets abroad at the end of the period reviewed, while the shares of the public sector and the banking sector contracted to 24 percent and 23 percent respectively. During the period reviewed, the share of the public sector in the balance of assets shrank by half (Figure 1).



Liabilities side: Nonresident investment in Israel

The balance of Israel's external liabilities expresses the total investment balance of nonresidents in Israel. Israel's balance of liabilities grew by 95 percent in the period reviewed. Most of the growth was in direct investment which increased by 260 percent, while portfolio investment grew by 140 percent and other investment saw a more moderate growth of 24 percent (Table 1). The increase in nonresident investment in the Israeli economy reflects the level of confidence that foreign investors have in the Israeli economy in general and in its high-tech sector in particular. This trend of growing foreign investment in Israel has been characteristic of investment in emerging markets in recent years (Figure 2), mainly by developed

countries which, *inter alia*, have sought to diversify their investments, with the aim of achieving higher returns.

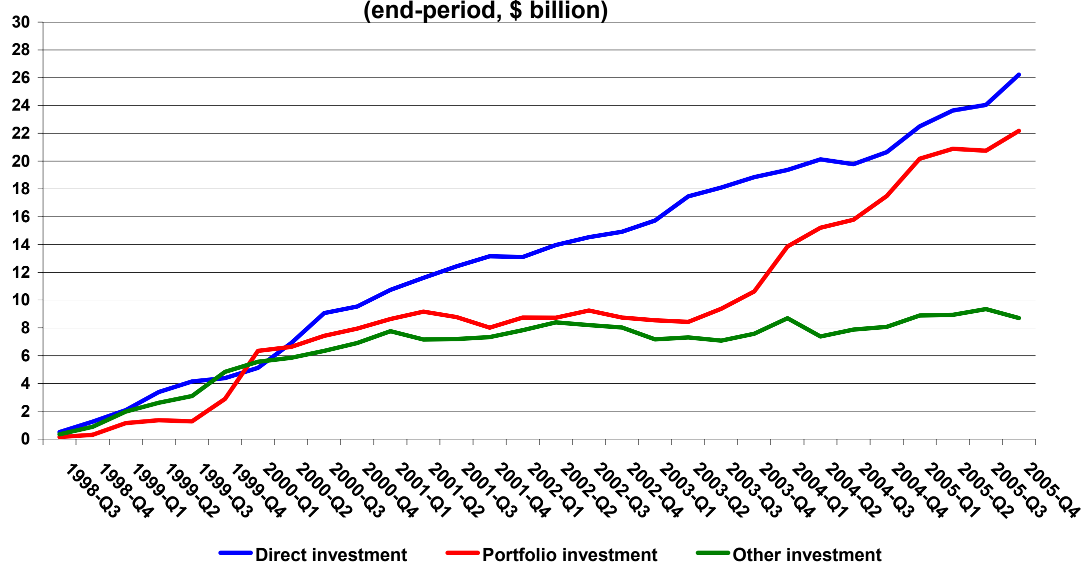


Source: Capital Flows to Emerging Market Economies, Institute of International Finance, October 2004 and January 2006 and Bank of Israel.
Data on Israel are not included in the IIF reporting.

Analyzing the investment flows shows that nonresidents invested a total $ 57 billion in Israel in the period reviewed: 46 percent in direct investment, 39 percent in portfolio investment and 15 percent in other investment (Figure 3).

The flow of direct investment over the period reviewed totaled $ 26 billion, most of which—about 80 percent—was in non-traded companies, and the rest, investment in real estate and shareholder loans. The flow of portfolio investment totaled $ 22 billion in the period of which 69 percent was in shares, the rest in bonds. Direct investment is especially important due to its contribution to GDP and growth, and due to its long-term nature, which contributes to economic stability.

Figure 3: Nonresident Cumulative Investment Capital Flows by Investment Type (end-period, $ billion)



Source: Bank of Israel

Other developments in the financial account

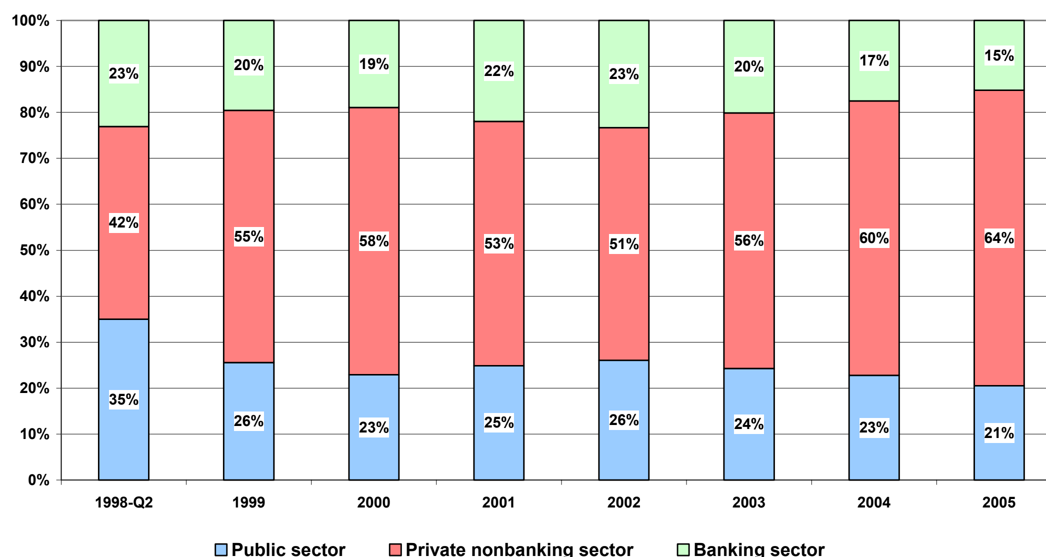
An analysis of **net liabilities** (external liabilities *minus* assets abroad), by sector shows the following. The balance of **net liabilities** of the private nonbanking sector rose from $ 21 billion at the beginning of the period to $ 32 billion at the end, and the public sector (the government and the Bank of Israel) reduced their net liabilities from about $ 5 billion to $ 2 billion; while the banking sector moved from net liabilities of $ 5 billion to a **net asset surplus** of $ 5 billion (Table 2). Opening the Israeli economy to the global economy brought further opportunities to Israeli companies in raising funds on the financial markets through shares and bonds. As a result, the private nonbanking sector saw its share of liabilities rise to 64 percent by the end of 2005. Israeli companies' turning to overseas markets for funds brought with it a contraction in the banking sector's share of liabilities abroad to 15 percent at the end of the period (Figure 4). An even greater fall could be seen in government financing from abroad: the share of the public sector in Israel's total liabilities fell to 21 percent. In the 1980s the government was the major source of foreign exchange to the Israeli economy, while today the now-matured private nonbanking sector manages to supply most of the foreign currency needs, and requires less assistance from "financial intermediaries", i.e. the government and resident banks.

Table 2: Israel's External Assets and Liabilities (IIP) by Sector
($ billion)

	Balance 30.6.98	Balance 31.12.05	Nominal Change	Cumulative Flows
Assets	**47**	**123**	**76**	**68**
Public sector	22	29	7	5
Private nonbanking sector	12	66	54	48
Banking sector	13	28	15	16
Liabilities	**78**	**153**	**75**	**57**
Public sector	27	31	4	4
Private nonbanking sector	33	98	66	49
Banking sector	18	23	5	5
Net Liabilities	**31**	**30**	**-1**	**-11**
Public sector	5	2	-3	-1
Private nonbanking sector	21	32	11	1
Banking sector	5	-5	-10	-11

Source: Bank of Israel.

Figure 4: External Liabilities Balances by Sector
(end-period)



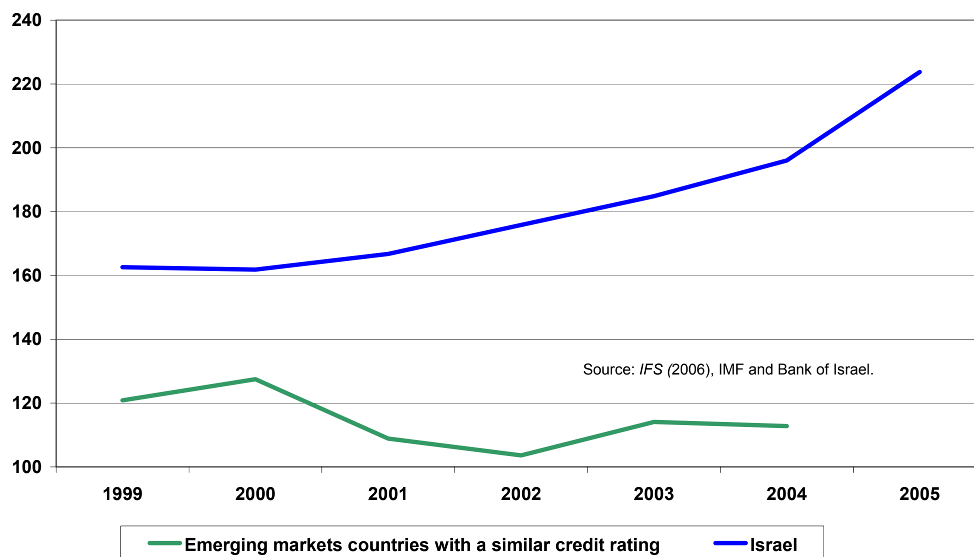
Source: Bank of Israel

One of the measures of the financial openness of the economy is its **balance of total external assets and liabilities as a percentage of GDP**. This measure in Israel rose from about 118 percent at the end of 1997 to 226 percent at the end of 2005. Comparing Israel to other emerging economies, having a similar long-term foreign currency credit rating as Israel[5], shows that Israel seems to have a higher degree of openness than these other emerging economies. During the period reviewed this index

[5] Chile, the Czech Republic, Thailand, Hungary, Poland and South Korea.

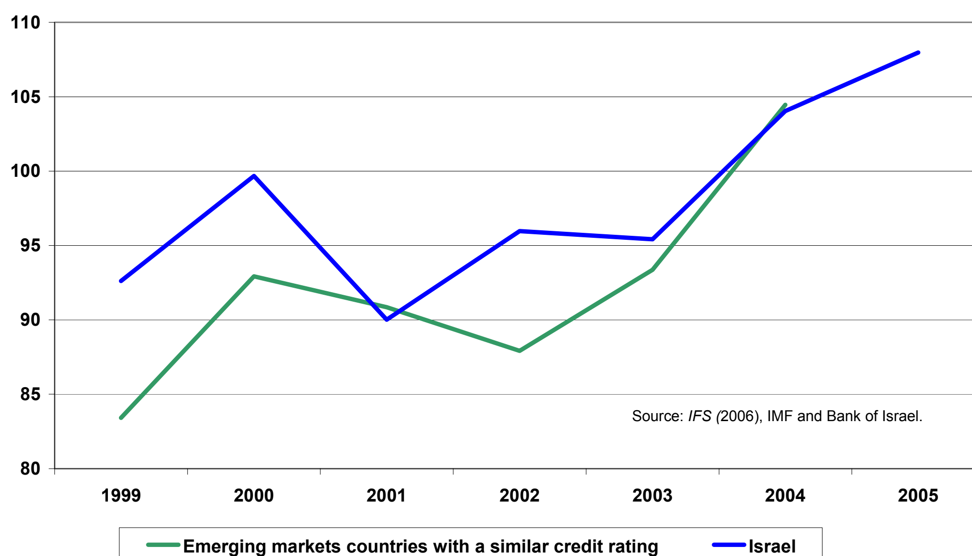
of financial openness grew significantly, reflecting the considerable expansion in financial activity in Israel, while in the other emerging economies examined the index of financial openness remained more or less constant (Figure 5).

Figure 5: Ratio of Assets and Liabilities in the Finacial Account to GDP (end-period, percent of GDP)



In the period reviewed real activity of the Israeli economy also grew. One measure of the **real openness** of an economy is the **total of exports and imports as a percentage of GDP**. Comparing Israel to other emerging markets shows that this trend is characteristic of the past three years among other emerging economies similar to Israel (Figure 6).

Figure 6: Ratio of Exports and Imports to GDP (end-period, percent of GDP)

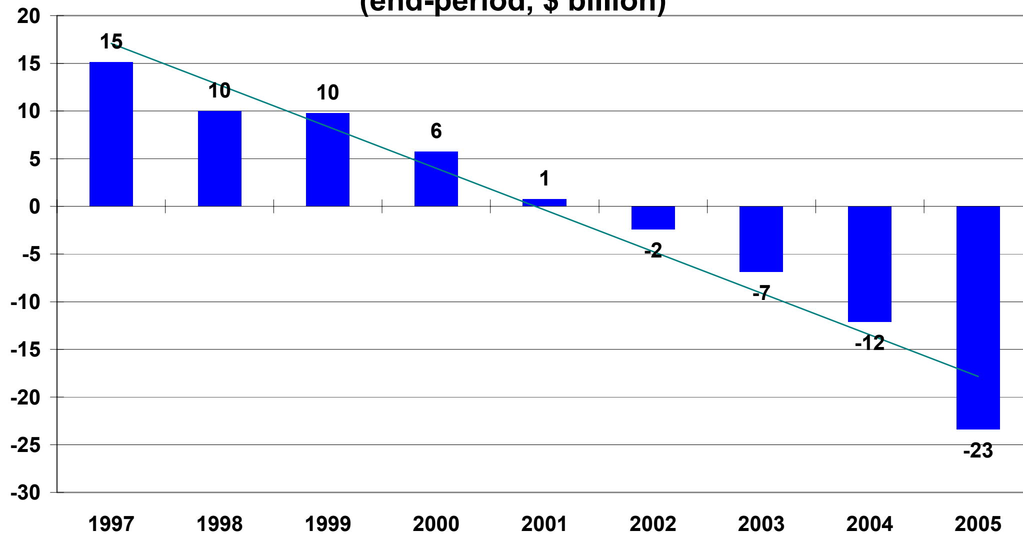


The expansion in the financial account was expressed both on the assets and the liabilities side. The ratio of **the balance of assets to GDP** grew during the period reviewed by 114 percent while the ratio of **the balance of liabilities to GDP** grew by 95 percent. These figures show that resident investment abroad expanded more than nonresident investment in Israel. A possible explanation for this is that Israel was "formally" exposed to nonresidents already in 1995—when the international credit rating agencies began rating Israel's credit risk, allowing the government to issue tradable bonds abroad in the same year and Israeli companies to issue tradable bonds abroad from the following year—while in contrast resident investment abroad was still subject to restrictions up to 1998. Only with the removal of these restrictions and the ending in 2003 of the tax discrimination on investment in foreign assets did the flow of resident investment abroad begin to accelerate.

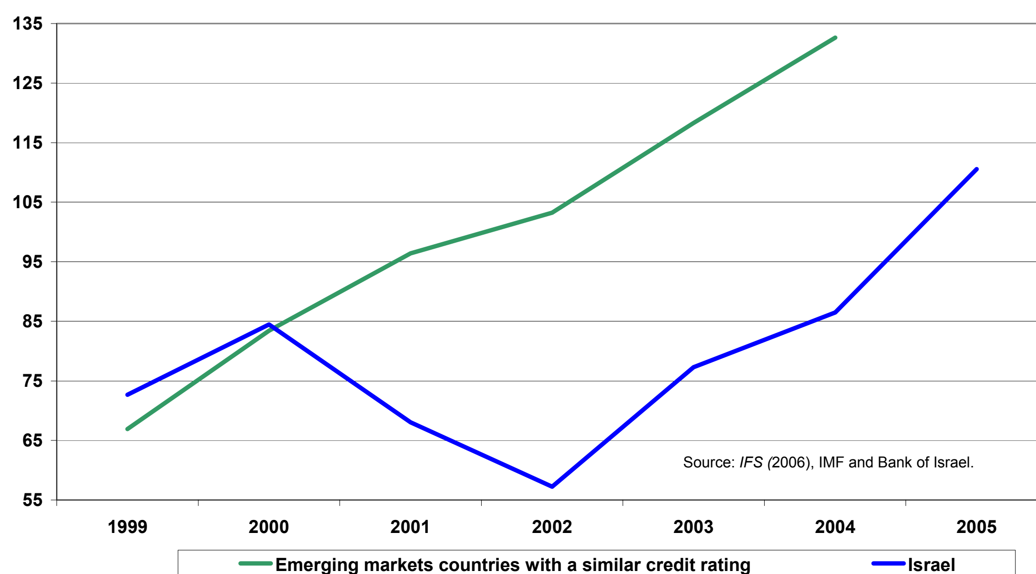
These trends affected changes in Israel's **net external debt**, which is defined as gross external debt (debt instruments) *minus* assets abroad (debt instruments). The balance of the net external debt has been gradually contracting since 1996 in a process that has intensified since the liberalization of the foreign exchange market: assets abroad have consistently increased until the balance of external assets exceeded the balance of the external debt. As a result, in 2002, the Israeli economy moved from being a net borrower to being a net lender, and at the end of the period reviewed Israel's **net asset surplus** (debt instruments) reached a balance of $ 23 billion (Figure 7). Israel's having a net surplus of debt instrument assets stems from the fact that during the period reviewed most of the growth in the economy's assets was in debt instruments, while most of the growth in the economy's liabilities was in equity securities.

Analyzing net external debt by term to maturity (forward amortization) shows that Israel has a large surplus of short-term assets, as most of the government debt is long term, and the Bank of Israel's reserve assets and the external assets of the private sector are mostly short term. This **surplus in short-term assets** reached around $ 40 billion at the end of 2005. This surplus in assets and surplus in short-term assets contribute to the economy's financial strength and its ability to meet its contractual liabilities abroad, while also constituting the central component in evaluating the economy's risk by the international rating agencies and risk analysts.

One of the measures used by nonresidents to examine Israel's credit risk is the credit risk rating by the international rating agencies. Israel holds a rating of **A-** from **S&P** (since December 1995) and **A2** from **Moody's** (since July 2000). These ratings indicate Israel's strong payment capacity and allows the Israeli government to issue bonds abroad at a relatively low cost.

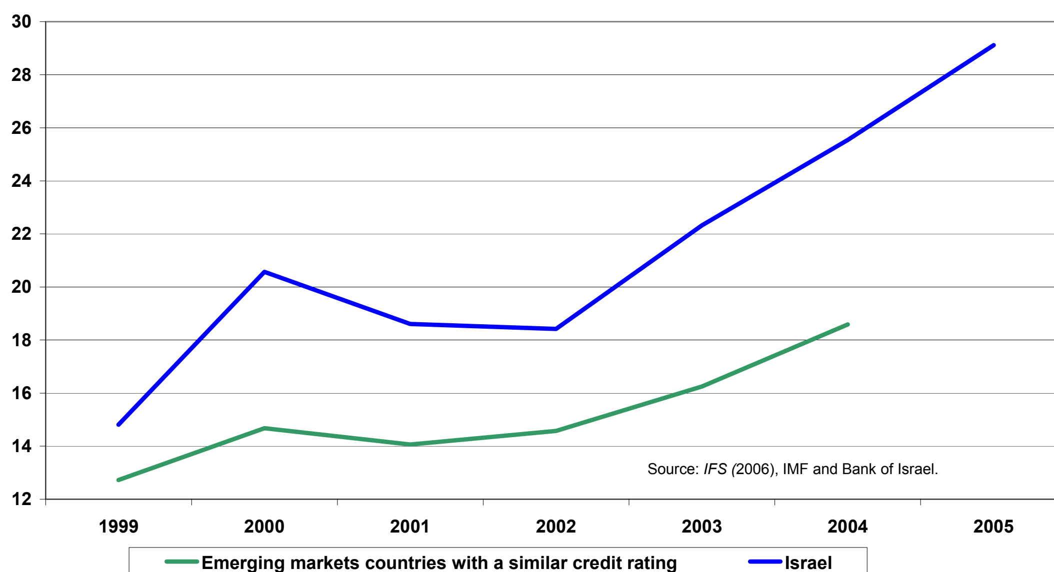


One of the measures of the stability of the economy regarding financial liabilities is the ratio of the **balance of investment in equity to the balance of investment in debt instruments** (Figure 8). This ratio stood at 74 percent in 1999 and reached 111 percent in 2005, as a result of the growth in the share of foreign investment in Israeli equity. This ratio fluctuated during the period reviewed, rising significantly from 1998 to 2000—reaching 84 percent at the end of 2000— and then plummeting after the US stock market "bubble" burst at the end of 2000, reaching a low of 57 percent at the end of 2002. Since 2002 the ratio has consistently increased, up to the end of the period reviewed. The growth in nonresident equity investment was mostly in non-traded companies and Israeli companies traded abroad. Comparing Israel's ratio of investment in equity to debt instruments to that of its peers among the emerging economies shows a similar trend in recent years, although the ratio is higher in the other emerging markets. One possible explanation for this is that emerging economies register relatively high rates of growth, and foreign investors, seeking higher returns on equity, find attractive companies in these economies. The drop in this ratio in Israel in 2001 and 2002, compared to a continued upward trend among other emerging economies is explained by Israel's being an economy with a strong high-tech bias and therefore the bursting of the US stock market "bubble" caused a sharp drop in the balance of nonresident investment in equity.



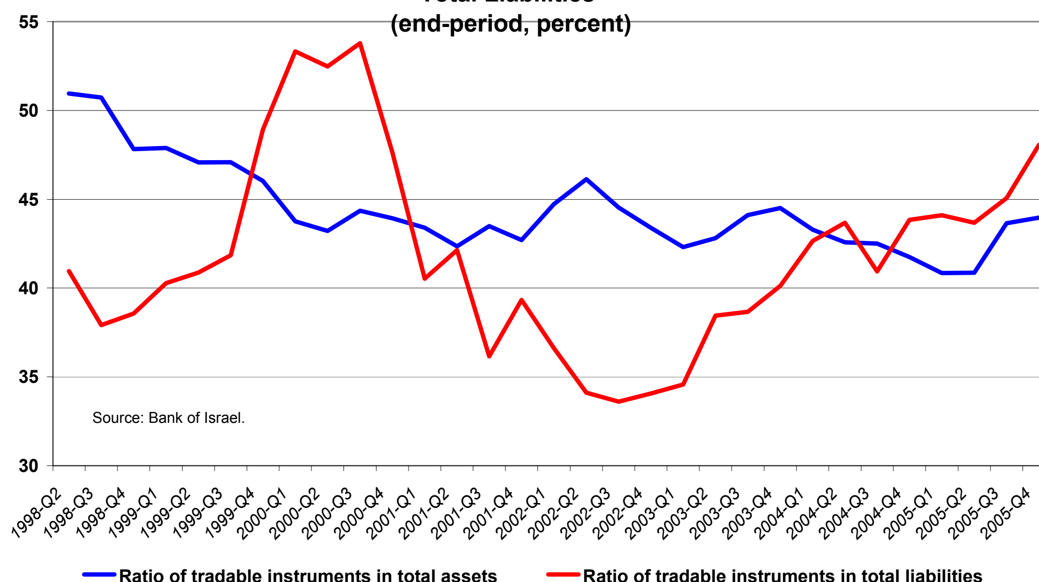
On the **assets side**, the ratio of equity to debt instruments rose from 15 percent at the end of 1999 to 29 percent at the end of 2005 (Figure 9). Despite this increase, most of resident investment abroad is still in debt instruments. Other emerging economies show similar trends although their ratios are lower than Israel's. The Israeli economy today is greatly increasing its investment in equity, mostly on the part of institutional investors. An examination of the share of the Israeli public's financial assets abroad vis-à-vis the Israeli public's total financial assets—both in Israel and abroad—shows that the share of assets abroad has grown significantly in the period reviewed. The financial liberalization process in Israel which gained momentum in 1998 prompted many Israelis to invest overseas in order to obtain higher returns on their investments.

Figure 9: Ratio between Equity and Debt Instrument Assets (end-period, percent)



Another measure of the economy's openness is the **ratio of tradable instruments in total investment**, both from the assets and the liabilities side. An increase in the share of tradable liabilities reflects the increased integration of the Israeli economy with the global financial markets, and testifies to the ability of the various sectors in the economy to raise funds abroad. On the liabilities side, the share of tradable liabilities in total liabilities increased to 48 percent at the end of the period, whereas the share of tradable assets in total assets fell during the period to 45 percent (Figure 10). The share of tradable liabilities varied considerably during the period reviewed: From 1999, the share of tradable liabilities increased significantly to reach a record 54 percent in 2000, as a result of the accelerated development of the Israeli high-tech industry which caused an increase in nonresident tradable investment in Israel; at the end of 2000—following the crisis in the global high-tech industry, the drop in share prices and the downturn in the industry's activities—nonresident tradable investment fell and their share dropped to 34 percent in September 2002; at the end of 2002 the hi-tech industry registered a recovery, with nonresidents returning to invest in tradable assets in the economy.

Figure 10: Ratio of Tradable Instruments in Total Assets and in Total Liabilities



Conclusion

In the period from 1998 to 2005, the Israeli economy's financial activity vis-à-vis abroad grew faster than GDP. Israelis invested $ 68 billion abroad while nonresidents invested $ 57 billion in Israel. The high level of activity vis-à-vis abroad was a result of liberalization in the foreign exchange market, which offered new possibilities for Israelis to raise capital abroad and to invest abroad. This, combined with the process of globalization was reflected, *inter alia*, in increased international capital flows in both nonresident investment in Israel and resident investment abroad. Tax reform that reduced the discrimination and distortion in taxation of financial assets according to investment venue also contributed to increased capital flows. The share of nonresident investment in equity and foreign direct investment in Israel rose significantly; the proportion of tradable investment in the economy also grew to a certain extent; all of which contributed to a change in the composition of Israel's assets and liabilities portfolio.

The opening up of the Israeli economy vis-à-vis abroad affected primarily the private nonbanking sector which in the past few years raises capital in international financial markets and is in less need of the traditional financial intermediaries, namely the government and domestic banks; as a result of which the share of the government and domestic banks in the economy's total external liabilities fell while that of the private nonbanking sector grew. The expanded activity of the private nonbanking sector also brought about an impressive growth in its assets abroad. This considerable growth in assets abroad, while external liabilities grew more moderately, resulted in the economy registering a net (debt instrument) asset surplus abroad from 2002 onwards.

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