

## Chapter 6

# The Balance of Payments

*The current-account balance-of-payments deficit grew substantially in 1995, to some \$4.1 billion, reflecting an increase in the deficit in the goods and services account in the context of a serious deterioration in the terms of trade. The widening of the current-account deficit expresses the growth of investment and a fall in the saving rate which stemmed from the public sector. Capital inflow was greater than that required to finance the current-account deficit. The deficit in the basic account indicates, however, that the current-account deficit was financed by the import not only of long-term capital, but of short-term capital, too, which reached an unprecedented level in 1995. The capital inflow occurred against the background of the Bank of Israel's firm resolve to adhere to a policy of high interest rates in order to achieve the inflation target. Despite Israel's improved international standing, and positive indicators such as the debt/GDP ratio and the number of import months covered by the foreign-currency reserves, a fiscal policy which will reduce the current-account deficit is required, since the deficit and its financing cannot be sustained.*

### 1. MAIN DEVELOPMENTS

The current-account balance-of-payments deficit grew by \$1.6 billion in 1995, to \$4.1 billion. The increase was entirely due to the \$1.7 billion rise in the import surplus, slightly offset by a \$0.1 billion expansion in unilateral transfers.

The deterioration in the terms of trade, which was a major factor behind the rise in the import surplus, was the result of a faster rise in world prices of raw materials than in prices of industrial goods, as well as of the dollar's weakness in international money markets. The terms of trade deteriorated by 5 percentage points in 1995, following a 2 percentage point fall in 1994, and it is estimated that they accounted for some 60 percent of the rise in the import surplus. Real appreciation persisted but moderated; export prices rose more slowly than product prices.

The widening of the gap between investment and national savings is reflected by the larger current-account deficit. Investment's share in total income grew. There was large-scale investment both in the context of immigrant absorption and the adjustment of capital stock to the larger labor force, and in response to the new business opportunities afforded by the political developments in the region. The rate of saving declined, however. While private savings increased, public saving fell, and did not serve as a policy tool to offset the effect on the balance of payments of the deterioration in the terms of trade.

**Table 6.1**  
**Selected Balance of Payments Indicators, 1987-95**

	1987-92	1993	1994	1995
<i>\$ billion, at current prices</i>				
Total current account	0.2	-1.3	-2.5	-4.1
Adjusted current account <sup>a</sup>	0.3	-1.0	-2.4	-4.1
Import surplus				
Total	5.7	7.9	9.4	11.1
Civilian <sup>b</sup>	3.9	5.8	7.9	9.8
Civilian, excl. capital services	2.6	4.6	6.3	8.4
Net unilateral transfers				
To public sector	3.6	3.6	3.3	2.9
To private sector	2.1	3.0	3.6	4.1
Implied private capital imports <sup>c</sup>	-0.6	1.0	1.4	6.4
External debt <sup>d</sup>				
Net	16.6	16.8	17.7	19.2
Gross	32.9	36.9	41.2	44.3
Foreign reserves	6.1	7.1	7.3	8.7
<i>change, percent (volume)</i>				
Exports <sup>e</sup>	5.2	12.6	9.1	9.5
Civilian imports <sup>e</sup>	8.3	11.2	13.2	8.2
World trade <sup>f</sup>	6.1	3.9	8.7	7.9
Exchange rate (in NIS)				
Against the dollar	1.98	2.83	3.01	3.01
Against the 5-currency basket	2.14	3.06	3.30	3.46
Net external debt as percent of <sup>d, g</sup>				
GDP	33.3	26.3	23.2	22.5
Exports	95.5	73.2	69.9	64.8
Price indices (1988=100)				
Imports/GDP <sup>h</sup>	94	79	75	75
Exports/GDP <sup>h</sup>	95	84	79	76
Terms of trade <sup>i</sup>	99	101	99	94

<sup>a</sup> Adjusted for advances on defense imports.

<sup>b</sup> Excluding direct defense imports.

<sup>c</sup> See this item in Table 6.9.

<sup>d</sup> The external debt has not been adjusted by the part of US aid received in February 1996.

<sup>e</sup> Excluding diamonds and capital services.

<sup>f</sup> Based on IMF, *World Economic Outlook*, October 1995.

<sup>g</sup> Net external debt at end of year. GDP at end-of-year current prices.

<sup>h</sup> Price index of imports (exports) *divided by* price index of GDP (from the national accounts); excludes diamonds.

<sup>i</sup> Excludes capital services and diamonds.

Exports (excluding diamonds and capital services) increased more slowly than in previous years, and in line with the rate of expansion of world trade. Israel maintained its share of world trade, but failed to increase it, despite the considerable investment of recent years and the opening up of new markets. Most of the slowdown in the rate of volume growth was in industrial exports (excluding diamonds). The lower profitability of exports—expressed *inter alia* by a more rapid rise of domestic than export prices—played a part in this, as did the sharp increase in prices of imported intermediates. The difficulties encountered in defense exports and the marked decline in exports of transport equipment, some of which is defense related and characterized by wide fluctuations, also contributed. The geographical distribution of exports and imports indicates a measure of adjustment to changes in cross rates.

Total unilateral transfers increased in 1995, reflecting the continued growth of transfers to the private sector. Taking a long-term view, it can be seen that some of these transfers are sensitive to differences between domestic and foreign interest rates, and their development indicates a correlation with short-term capital flows.

In 1995 the current-account deficit was financed by capital inflow and domestic foreign-currency sources made available by the banks to the nonfinancial private sector—in the context of the Bank of Israel's tight monetary policy and, apparently, as a result of reduced expectations of a rise in the exchange rate. Total implied capital inflow was about \$5.2 billion, alongside private-sector foreign-currency conversions (of about \$6.2 billion), and a rise in the reserves. The reserves rose only slightly during the year relative to the extent of conversions, due to withdrawals of foreign-currency deposits from the Bank of Israel by the banks and the government—used to extend foreign-currency credit to the business sector.

The extent of conversions reflects the Bank of Israel's intervention in the foreign-currency market, aimed at preventing significant local-currency appreciation against the currency basket in view of the huge capital inflow. Nevertheless, in the second half of the year the central bank did allow the exchange rate to reflect market forces more closely than in the past, and to fall below the inner band within which it had fluctuated since 1993. This followed the widening of the crawling band around the midpoint rate in June 1995, intended to increase the range of potential fluctuation of the exchange rate. In mid-December the public purchased foreign currency, while the rise in the exchange rate accelerated. These purchases reflected expectations of government budget cuts early in 1996, and of a subsequent reduction of local-currency interest, making it less worthwhile to take foreign-currency credit. When the cuts fell short of expectations, capital inflow resumed at the beginning of 1996, as did foreign-currency conversions and local-currency appreciation.

In contrast with other similar situations in the past, the current-account deficit in 1995 was financed by capital inflow without a fall in the reserves, to some extent concealing the gravity of the balance-of-payments problem to which the deficit in the basic account attests. This deficit indicates that short-term capital inflows financed much of the current-account deficit, reinforcing fears raised in 1994 that such a large current-account

**Table 6.2****Net Balance of Payments, 1993-95<sup>a</sup>**

	(\$ million at current prices) <sup>b</sup>		
	1993	1994	1995
<b>Goods and services account</b>	<b>-7,940</b>	<b>-9,370</b>	<b>-11,090</b>
Private sector	-4,701	-6,419	-8,549
Public sector <sup>b</sup>	-3,239	-2,951	-2,541
<b>Unilateral transfers<sup>c</sup></b>	<b>6,675</b>	<b>6,901</b>	<b>7,004</b>
Private sector	3,032	3,624	4,135
Public sector	3,643	3,277	2,869
<b>Current account</b>	<b>-1,265</b>	<b>-2,469</b>	<b>-4,086</b>
Private sector	-1,669	-2,795	-4,414
Public sector	404	326	328
<b>Medium- and long-term capital movements</b>	<b>2,152</b>	<b>2,708</b>	<b>2,230</b>
Private sector <sup>d</sup>	131	638	1,559
Public sector	2,021	2,069	672
<b>Basic account</b>	<b>887</b>	<b>239</b>	<b>-1,856</b>
Private sector	-1,538	-2,157	-2,855
Public sector	2,425	2,395	1,000
<b>Short-term capital movements</b>	<b>-309</b>	<b>-90</b>	<b>-183</b>
Nonfinancial private sector	-567	-104	995
Public sector <sup>e</sup>	258	14	-1,178
<b>Capital movements of banking sector</b>	<b>522</b>	<b>-1,229</b>	<b>1,037</b>
<b>Errors and omissions</b>	<b>380</b>	<b>1,150</b>	<b>2,150</b>
<b>Change in foreign reserves<sup>f</sup></b>	<b>-1,480</b>	<b>-70</b>	<b>-1,148</b>
<b>Implied capital inflow</b>	<b>2,745</b>	<b>2,539</b>	<b>5,234</b>

<sup>a</sup> Figures may not add due to rounding.

<sup>b</sup> The deficit on the public-sector goods and services account is defined as direct defense imports *plus* other government imports *plus* net interest payments abroad *less* other income.

<sup>c</sup> The 1995 figure includes \$1.2 billion of US economic aid, although \$950 million of this was received in February 1996

<sup>d</sup> Includes net investment from abroad by individuals, line 7, Table 6.10 *plus* net receipts of the nonfinancial private sector, line 3b, Table 6.8. The classification of investments into long-term capital movements is approximate

<sup>e</sup> The share of US economic aid received in February 1996 is included in the 1995 figure of capital outflow.

<sup>f</sup> Increase (-)/decrease (+); adjusted for dollar exchange rate of currencies.

SOURCE: Based on Central Bureau of Statistics data.

deficit is unsustainable. If there is no real improvement in the balance of payments based on curtailing government expenditure and the budget deficit, and if short-term capital inflow and the deviation of the nominal exchange rate from the midpoint rate persist, expectations of a rise in the exchange rate will emerge. In such circumstances the inflation target will not be achieved, and Israel's creditworthiness abroad will deteriorate.

The long-term credit line associated with the US government loan guarantees and the level of the foreign-exchange reserves allow Israel 'breathing space,' and alleviate the problem in the short term. This credit line will be exhausted in just two years, however, and in the absence of measures to dampen demand it will be difficult to reduce the current-account deficit.

Long-term capital imports by the public sector contracted, while those of the nonfinancial private sector expanded considerably, mainly due to the increase of foreign direct investment in Israel. These investments reflected *inter alia* the political developments in the region and Israel's vigorous economic growth in recent years—which have apparently reduced its country risk.

The current-account deficit was reflected by the continued growth of the external debt. The recorded rise in the external debt was significantly lower than that implied by the size of the current-account deficit after the deduction of net foreign investment, as it does not include unreported capital movements, which in 1995 indicated a significant capital inflow. Despite the marked rise in the external debt which, as stated, is an underestimate of the true external debt, the ratios of the debt to exports and to GDP fell. The decline in the latter reflects both the significant real increase in GDP and the rise in the exchange rate against the dollar, which was moderate relative to the rise in the price of GDP.

## 2. THE CURRENT ACCOUNT

### General review

The current-account deficit totaled \$4.1 billion in 1995, compared with \$2.5 billion in 1994. Net unilateral transfers rose by about \$0.1 billion. The import surplus, i.e., the current-account deficit *less* these transfers, amounted to \$11.1 billion. Since defense imports are financed mainly by earmarked aid, attention here is focused on the civilian import surplus, which increased by \$1.9 billion to \$9.8 billion.

The increase in the import surplus is the result of the volume changes in exports relative to imports and of price changes. In 1995 the latter effect predominated. As Israel's imports exceed its exports, the import surplus grows even when import and export prices rise *pari passu*. Assuming that world prices rose by 2.5 percent in 1995, this accounted for some \$0.2 billion of the deficit. Over and beyond this price factor, Israel's terms of trade deteriorated, dollar prices of exports rising by 4.8 percent, and those of civilian imports by 8.4 percent. This deterioration contributed about \$1.2 billion to the increase in the civilian import surplus (excluding capital services). The estimate does not fully take into account the volume changes in imports and exports resulting from the change in their relative prices. These changes reflect *inter alia* the negative effect of the change in the terms of trade on national income.

The worsening of Israel's terms of trade, much of which reflects international developments, was more pronounced in 1995, when it accounted for some 60 percent of the rise in the import surplus, than in 1994, when it contributed less than 40 percent.

International developments were translated into a deterioration of the terms of trade because of two aspects of the composition of Israel's trade: first, exports consist largely of industrial goods, whereas a large share of imports consists of raw materials. Since 1993, world prices of raw materials have risen at a higher annual rate than those of industrial goods. This is related to international business cycles, and although its negative effect on Israel's terms of trade was evident in 1994, it worsened in 1995.

The second characteristic of Israel's trade relates to its currency composition. The share of the dollar in exports is greater than it is in imports, so that its weakness results in import prices rising more than export prices, and accounted for some 40 percent of the deterioration of the terms of trade.

Exports (excluding capital services) rose by 10 percent at constant prices, more slowly than in any of the last three years. Excluding diamonds and exports to the Autonomy and the administered areas, the increase was only 8.1 percent, compared with 11.4 percent in 1994, and similar to the growth of world trade. At the same time, the 8.2 percent volume growth of civilian imports (excluding diamonds and capital services) was the lowest since 1991. The higher volume rise of imports than of exports explains some \$ 700 million of the total \$ 2.1 billion increase in the civilian import surplus (excluding capital services) in 1995.

Table 6.4 shows the estimated contribution to the rise in the civilian import surplus of the various components (excluding capital services).

The increase in the current-account deficit reflects the widening of the gap between investment, whose share in total income rose in 1995, and savings, whose share fell. Although the private saving rate rose slightly, this was insufficient to offset the greater decline in public savings. The share of public consumption in GDP (at current prices) increased slightly, and the budget deficit grew, exceeding the planned domestic deficit. The rise in the deficit came just at a time when budgetary policy should have reacted to the deterioration in the terms of trade, and moderated the rise in the import surplus due to exogenous factors. The threat to the current account represented by fiscal policy will be even greater if it turns out that the decline in public-sector saving is not temporary.

Differences in the rates of growth of domestic demand and GDP are generally the result of changes in both volume and relative prices. The former will be reflected by a change in the import surplus/GDP ratio, and in 1995 this ratio fell slightly. The change in relative prices may be reflected by a rise in domestic prices at a different rate from those of imports and exports. Export prices rose more slowly than those of GDP in 1995, so that real appreciation persisted, albeit more slowly than in 1994. A deterioration in the terms of trade could itself be expected to cause real depreciation in the export exchange rate, by

**Table 6.3**  
**Goods and Services Account, 1993-95<sup>a</sup>**

	\$ million		Annual change, percent					
			Price			Quantity		
	1994	1995	1993	1994	1995	1993	1994	1995
<b>Imports</b>								
Goods excl. fuel and diamonds <sup>b</sup>	17,174	20,789	-3.7	2.0	11.0	13.3	15.8	9.0
Fuel	1,658	1,999	-11.3	-2.5	10.9	14.6	-2.4	8.7
Diamonds	3,873	4,429	0.6	4.2	-4.6	14.0	11.2	19.9
Services <sup>b,c</sup>	7,329	8,527	0.2	1.7	9.3	15.7	18.6	6.5
Total civilian imports <sup>d</sup>	24,503	29,316	-2.6	1.9	10.5	14.0	16.6	8.3
From administered areas <sup>e</sup>	538	615	5.9	21.6	10.6	-37.7	-42.7	3.2
Subtotal	<b>30,573</b>	<b>36,359</b>	<b>-2.6</b>	<b>2.2</b>	<b>8.4</b>	<b>11.5</b>	<b>13.0</b>	<b>9.7</b>
Capital services	2,664	3,069						
Direct defense imports	1,485	1,314						
<b>Total imports</b>	<b>34,722</b>	<b>40,742</b>						
<b>Exports</b>								
Goods, excl. diamonds <sup>b</sup>	11,802	12,927	-3.5	-0.7	5.5	18.1	14.0	3.8
Diamonds	4,014	4,625	9.9	-3.4	2.6	0.1	23.8	12.3
Services <sup>b,c</sup>	7,479	8,953	-2.7	1.3	4.1	9.2	7.4	15.0
Total <sup>d</sup>	19,281	21,880	-3.2	0.1	5.0	14.4	11.4	8.1
To administered areas <sup>e</sup>	982	1,483	-5.6	1.4	11.1	-7.8	-22.1	35.8
Subtotal	24,277	27,988	-1.6	-0.5	4.8	10.7	11.3	10.0
Capital services	1,074	1,664						
<b>Total exports</b>	<b>25,352</b>	<b>29,652</b>						

Trade deficit <sup>b</sup>		
Excl. diamonds and fuel imports	5,372	7,862
Current surplus, diamonds	141-	195
Total trade deficit	6,889	9,665
Surplus on services account <sup>b,c</sup>	150	426
Civilian import surplus <sup>c</sup>	6,296	8,371
Capital services imports, net	1,590	1,405
Civilian import surplus	7,885	9,776
<b>Total import surplus</b>	<b>9,371</b>	<b>11,090</b>

<sup>a</sup> Imports c.i.f., exports f.o.b.

<sup>b</sup> Excluding the administered areas.

<sup>c</sup> Excluding capital.

<sup>d</sup> Excluding diamonds, fuel (in imports), capital services, and the Autonomy and the administered areas.

<sup>e</sup> The Autonomy and the administered areas.

SOURCE: Based on Central Bureau of Statistics data.



**Table 6.4****The Increase of the Civilian Import Surplus, by Component,  
Excluding Capital Services, 1994-95**

	(\$ billion)	
	1994	1995
Rise in world prices	0.1	0.2
Deterioration in terms of trade	0.6	1.2
Total price effect	0.7	1.4
Quantitative increase	1.0	0.7
Total increase in civilian import surplus	1.7	2.1

reducing income (assuming that the income effect outweighs the substitution effect). Nonetheless, as stated, there was real appreciation in 1995. This appears to have been the result of long-term factors such as growth and the switch of demand to nontradable goods which generally accompanies a rising standard of living. Exceptional public-services wage increases—which do not necessarily always reflect excess demand—also affected GDP prices. Adjusting for prices in this sector, appreciation was even more moderate in 1995. Prices of imports (excluding diamonds) rose slightly faster than those of GDP (9.8 and 9.3 percent respectively). The rise in import prices, however, was caused *inter alia* by the marked rise in world prices of raw materials, without which the gap between the rates of increase of import and GDP prices would have been even smaller, and may even have been reversed.<sup>1</sup>

Thus, prices of exports rose more slowly in 1995 than those of GDP, so that the fall in profitability of exports relative to domestic sales appears to have persisted. Relative profitability depends on conditions in both the export markets, where prices rose moderately, and the domestic market, where prices—particularly of nontradable goods—continued rising. Prices of tradable goods, exposed to competition from imports—the effect of which increases with liberalization—rose more moderately. The profitability of exports also suffered from higher world prices of imported intermediates, whose share is higher in production for export than for the domestic market. One of the effects of reduced profitability was some diversion of the supply of tradable goods from export to the domestic market. Another was the transfer of factors of production from tradable to nontradable goods. For the first time since 1992, the rate of increase of industrial exports was slower than that of industrial production (3.7 and 8.2 percent respectively). The diversion of supply does not immediately reflect the full deterioration in the profitability of exports, one reason being that there is insufficient domestic demand for some export goods, so that it takes time for the composition of production to adjust to domestic demand. Another reason is the fear of losing export markets, because of the high re-

<sup>1</sup> For a discussion of the factors affecting the real exchange rate see last year's edition of this *Report*.

entry costs. Exporters thus continue selling in these markets despite the erosion of profitability, if they believe the situation to be temporary.

Despite the fall in the profitability of exports in 1995, their volume increased in line with the expansion of world trade, so that this fall did not seem to affect exports. However, in contrast with 1992–94, in 1995 Israel's share of world trade did not increase, despite several developments which should have enabled this to occur. These include Israel's improved international standing and the weakening of the Arab boycott, resulting in new markets opening up; the considerable increase in capital stock in recent years; lower domestic prices of imported intermediates due to liberalization which allowed competing imports to push some manufacturers out of the domestic market, making them produce other goods, some for export. Long-term erosion of export profitability could have a negative effect on future growth, but even a temporary deterioration may result in the loss of some export markets.

The Bank of Israel's monetary policy, which emphasized the inflation target, created gaps between expected yields on local- and foreign-currency assets and credit. This led to a heavy inflow of short-term capital, and there were large-scale foreign-currency conversions. In the first half of 1995 the Bank of Israel intervened in the foreign-exchange market to prevent local-currency appreciation. In the second half, by contrast, the exchange rate fell below the midpoint rate, and the rate of nominal depreciation slowed. If there are downward rigidities in prices, such a slowdown may have some effect on export profitability. Nevertheless, profitability depends essentially on the real exchange rate, which is determined in the long run by real factors. Nominal depreciation might boost the profitability of exports if price rigidity were to cause real appreciation which does not reflect real economic conditions. If, however, appreciation does reflect real developments, particularly increased demand, the contribution of nominal depreciation will at most be slight and temporary, as can be seen from past attempts to deploy this instrument. On the other hand, nominal depreciation would accelerate inflation because of the great effect of the nominal exchange rate on price movements, especially in a situation approaching full employment. As stated, much of this year's appreciation was due to real rather than nominal developments. Thus, changes in the nominal exchange rate, particularly in the context of rising trade prices, did not contribute significantly to the erosion of export profitability in 1995. Nonetheless, the effect of the nominal exchange rate seems to have been evident towards the end of the year.

Identifying the sector worst affected might help to explain the slower expansion of exports. In 1995 there was a marked rise in diamond and agricultural goods exports. The diamond industry has low value added, and agricultural exports constitute only a small share of total exports. Services exports also expanded greatly. In contrast, industrial exports (excluding diamonds) rose by only 3.7 percent in terms of volume, significantly below their annual growth rate in 1992–94. Defense exports were hardest hit. If that category—which is facing a steep decline in world demand—is excluded, industrial exports (without diamonds) increased by about 7 percent in volume terms. The

calculation is based on a conservative estimate of the reduction in defense exports in 1995. If the prices of these exports rose more slowly than those of other exports, too—a reasonable assumption in view of the situation in the arms market—the estimate of the volume growth of exports excluding the defense industry (based on prices of all industrial exports) has an upward bias.

The significance of the increase in the import surplus and the ability to sustain it at its current level should be viewed from two aspects. One is the way it is financed, over and beyond unilateral transfers; this is discussed in Section 3 of this chapter (the capital account). The other is the factors leading to this increase, in particular, which of them are permanent and which temporary, and the extent to which they are connected to endogenous economic variables. As stated, in 1995 an exogenous factor, the deterioration of the terms of trade, was the prime cause of the rise in the import surplus. An analysis of the two components of the deterioration suggests that it may be temporary. The dollar weakened mainly in the first half of the year, since when it has strengthened. If this trend continues, or at least does not reverse, it may be expected to have a positive effect on the deficit. With regard to the second component, world prices of industrial goods are expected to rise in 1996, and those of raw materials to fall,<sup>2</sup> which would improve Israel's terms of trade. In the same way as the faster rise of raw material prices than that of manufactured goods' prices was not immediately reflected in the terms of trade, so too the prospective improvement may be felt only gradually. Despite this possibility, the assumption that the deterioration in the terms of trade is temporary should be treated with caution, and certainly economic policy should not be based on this optimistic assumption. An unpleasant surprise in this sphere could be very costly. In the long run imports and exports will react, albeit partially, to changes in the terms of trade by switching between export destinations and import sources according to changing cross rates, and altering their composition according to world prices.

The fact that industrial exports—which have the greatest expansion potential—suffered more than other exports in 1995, and the decline in the share of exports in industrial production raise two problems. First, the relative size of the exporting sector has a bearing on the ability to sustain the current-account deficit, because receipts for exports constitute the source for servicing the debt which finances it. Cutting the deficit by reducing imports is less appropriate for Israel because of the large share of intermediates and capital goods in its imports. Secondly, exports, not domestic (private and public) consumption, are the basis for sustainable growth, which determines the ability to maintain a deficit, *inter alia* through its effect on the debt/GDP ratio.

The significance of the reduction in defense exports is not unequivocal. On the one hand it seems to reflect the long-term problem of the steep and continued contraction of

<sup>2</sup> See IMF, *World Economic Outlook*, October, 1995.

**Table 6.5**  
**Merchandise Exports (f.o.b.), by Industry, 1993-95**

	\$ million		Annual change, percent					
			Price			Quantity		
	1994	1995	1993	1994	1995	1993	1994	1995
Agricultural exports	594	740	-4.4	-3.2	6.7	3.5	12.0	16.7
<i>of which</i> Citrus	126	200	18.0	6.1	17.9	-11.3	-1.4	34.3
Flowers	174	212	-12.4	-12.0	2.1	15.6	23.1	19.1
Industrial exports <sup>a</sup>	11,272	12,322	-3.5	-0.6	5.4	19.5	13.9	3.7
<i>of which</i>								
Textiles, clothing, leather	968	1,034	-5.7	1.3	3.4	3.2	8.1	3.3
Metals, machinery, electronics, transport equipment and electrical equipment	5,894	6,266	-1.4	1.0	5.2	25.8	15.4	1.0
<i>of which</i> Communications, control and medical equipment	2,407	2,468	-1.6	1.3	3.7	33.3	17.5	-1.1
Electronics and computers	945	1,097	-4.0	-0.3	3.4	39.1	8.5	12.3
Chemicals and oil refining	2,217	2,456	-5.9	-3.7	4.1	27.9	15.0	6.5
Polished diamonds (net)	3,554	3,940	10.5	-3.6	2.3	3.1	22.3	8.4
Unpolished diamonds (net)	461	684	4.6	-0.7	4.9	-19.2	35.7	41.5
Other exports <sup>b</sup>	240	287	-4.9	-17.0	3.6	2.2	5.3	15.4
Returned exports	69	95						
Net exports (FTS definition)	16,051	17,879	-0.1	-1.5	4.6	13.0	15.7	6.5
Balance-of-payments adjustments	-235	-327						
Exports to administered areas <sup>c</sup>	836	1,341	-6.0	0.7	11.3	-2.3	-18.2	44.1
Total exports	16,652	18,893	-0.5	-1.4	5.0	11.8	14.1	8.1
<i>of which</i> excl. diamonds and exports to the administered areas	11,802	12,927	-3.5	-0.7	5.5	18.1	14.0	3.8
<sup>a</sup> Excluding diamonds.								
<sup>b</sup> Excluding diamonds, including ships and aircraft.								
<sup>c</sup> The Autonomy and the administered areas.								
SOURCE: Based on Central Bureau of Statistics data.								

the world arms markets.<sup>3</sup> On the other, the long-term significance to the economy of the difficulty facing one particular industry is less pronounced, especially as most exporting defense industries are hi-tech, and movement of employees from them to civilian industries can be expected. The large-scale dismissals in the defense industries in recent years indicate that the adjustment process has started. Excessive government aid to these industries may hold the process back, delaying the transfer of factors of production to other, more profitable, export industries. The damage caused is greatest as the economy approaches full employment, which is most marked in hi-tech industries. In these circumstances exports can grow if labor is reallocated between the sectors, and not by increasing the number of employees. In any event, the falling share of defense exports in total exports in recent years mitigates the effect of that industry's crisis on the economy as a whole. Obviously, the more varied the composition of exports, the less vulnerable the economy is to shocks in the world terms of trade.

The gap between investment and savings, reflected by the current-account deficit, has two implications for the future. First, the rise in government expenditure has a relatively rigid component (public-services wage agreements) which is likely to affect the permanence of the reduction of public saving. Secondly, investment was extensive despite high interest rates. Investment is connected with the absorption of immigrants and the new conditions created by the peace process, enabling production to expand in the future. Nevertheless, if long-term interest falls, pressure on the balance of payments from investment is likely to build up. Moreover, some investments benefit from significant government subsidies. Apart from encouraging uneconomic investment, subsidies would serve to enlarge the import surplus.

## **Merchandise exports<sup>4</sup>**

### *Exports, by industry*

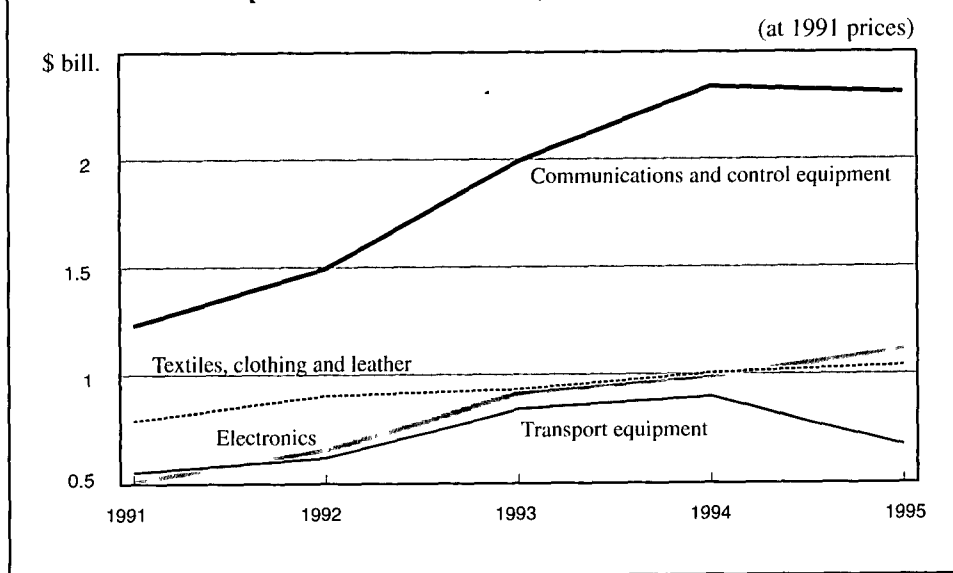
Industrial exports excluding diamonds (at constant prices) rose by less than 4 percent in 1995, after increasing by 14 percent in 1994 and 20 percent in 1993 (Table 6.5). This modest increase is all the more notable as their prices rose by 5 percent, slightly more than the rise in prices of industrial goods in world trade. Despite higher prices, the profitability of exports declined for the reasons given above.

Hi-tech industries—metals, machinery, electronics, transport and electrical equipment—account for some 50 percent of total industrial exports (excluding diamonds and exports to the Autonomy and the administered areas). Their exports rose far more slowly in 1995 than in 1993–94, partly due to the sharp decline in exports of transport equipment, which are characterized by wide fluctuations.

<sup>3</sup> The world arms trade has fallen drastically since 1987, and its volume in 1994 was less than half that in 1987. For details see *SIPRI Year Book 1995*, Oxford University Press 1995, pp. 510–11. This appears to be an overestimate of the damage to the demand for Israel's defense exports, if expertise in upgrading existing systems and the export of support items—which are not included in these data—are taken into account.

<sup>4</sup> Excluding diamonds and exports to the Autonomy and the administered areas.

**Figure 6.1**  
**Industrial Exports of Selected Industries, 1991-95**



Civilian communications exports surged by a nominal 23 percent in 1995; these have risen remarkably—threefold—since 1990. Other hi-tech exports also rose considerably. Electronics exports increased even faster in 1995 than in 1994, and exports of software rose by 27 percent (at current prices), after falling in 1993–94.

#### *Exports by geographical destination*

Exports to the EU rose markedly, whereas those to the US showed only moderate growth, following several years where the opposite situation prevailed. The change started in 1994, but was particularly notable in 1995, reflecting the weakness of the dollar which adversely affects the relative profitability of exporting to the US. This development may also reflect the improved relationship with the EU, in view of the peace process and the weakening of the Arab boycott.

The increase in exports to new markets in East Europe in 1995 outstripped the rise in all other markets. In 1994 exports to these markets did not increase at all, after rising very rapidly in 1992–93, characterizing the stage of market penetration. On the other hand, the growth rate of exports to other new markets—South America and East Asia (excluding Japan)—slowed markedly. The rise in exports to Japan is apparently related to the strengthening of the yen, Japan's increased imports in general, and the weakening of the Arab boycott against Israel. Exports to Asia, including Japan, represented 12.5 percent of Israel's total exports in 1995, compared with 7.3 percent in 1990.

**Table 6.6**  
**Merchandise Imports (c.i.f.), by Economic Use<sup>a</sup>, 1993-95**

	\$ million		Annual change, percent					
			Price			Quantity		
	1994	1995	1993	1994	1995	1993	1994	1995
Consumer goods	3,047	3,657	-0.7	0.5	7.5	9.9	19.6	11.6
<i>of which</i> Durables	1,498	1,811	2.5	1.9	7.1	0.2	14.6	12.9
Capital goods	4,510	5,006	-1.8	1.9	6.0	14.5	23.7	4.7
<i>of which</i>								
Machinery and equipment	2,962	3,468	-3.7	0.2	4.9	17.0	17.2	11.7
Land transport equipment	1,215	1,184	5.2	8.6	10.6	7.6	22.0	-11.8
Total intermediates	15,890	19,446	-4.6	2.4	8.6	13.3	9.6	12.7
Fuel	1,658	1,999	-11.3	-2.5	10.9	14.6	-2.4	8.7
Diamonds (net)	3,873	4,429	0.6	4.2	-4.6	14.0	11.2	19.9
Other	10,358	13,018	-5.3	2.5	14.0	19.9	11.4	10.3
Merchandise n.e.s. <sup>b</sup>	-77	-74						
Subtotal: FTS <sup>c</sup> definition	23,369	28,035	-3.7	2.0	8.0	13.1	13.3	11.0
Balance-of-payments adjustments	-664	-817						
From administered areas <sup>d</sup>	130	205	-6.0	1.1	10.5	-24.0	-27.9	42.9
Total imports <sup>e</sup>	22,835	27,422	-3.7	2.0	8.1	13.0	13.1	11.1
Total excl. fuel, diamonds and imports from administered areas <sup>d</sup>	17,174	20,789	-3.7	2.0	11.0	13.3	15.8	9.0

<sup>a</sup> Excluding direct defense imports.

<sup>b</sup> Net of returned imports.

<sup>c</sup> Foreign-trade statistics.

<sup>d</sup> Autonomy and administered areas.

<sup>e</sup> Total civilian imports, net, as per balance of payments.

SOURCE: Based on Central Bureau of Statistics data.

## Civilian merchandise imports

The volume of civilian merchandise imports (excluding fuel, diamonds, and imports from the Autonomy and the administered areas) increased by 9 percent in 1995, less than in any year since 1993. Imports rose more slowly in 1995 than in 1994 in all categories (Table 6.6), most notably in capital goods. Prices of imported merchandise rose by 11 percent, compared with a 2 percent increase in 1994. Prices of consumption and capital goods rose more moderately. In contrast, there was a 14 percent jump in prices of intermediates (excluding fuel and diamonds), although world raw material prices rose by only 9 percent.

### *Liberalization, and imports by geographical origin*

The slowdown in the rate of increase of merchandise imports encompassed all countries of origin, except for EFTA and unclassified countries, but to different extents. The increase in imports from the EU, East Europe, and America (excluding the US) eased most. The growth of imports from the US slowed far more moderately, this being consistent with the weakness of the dollar, which made them more competitive relative to

**Table 6.7**  
**Import Taxation, Selected Years 1980-95<sup>a</sup>**

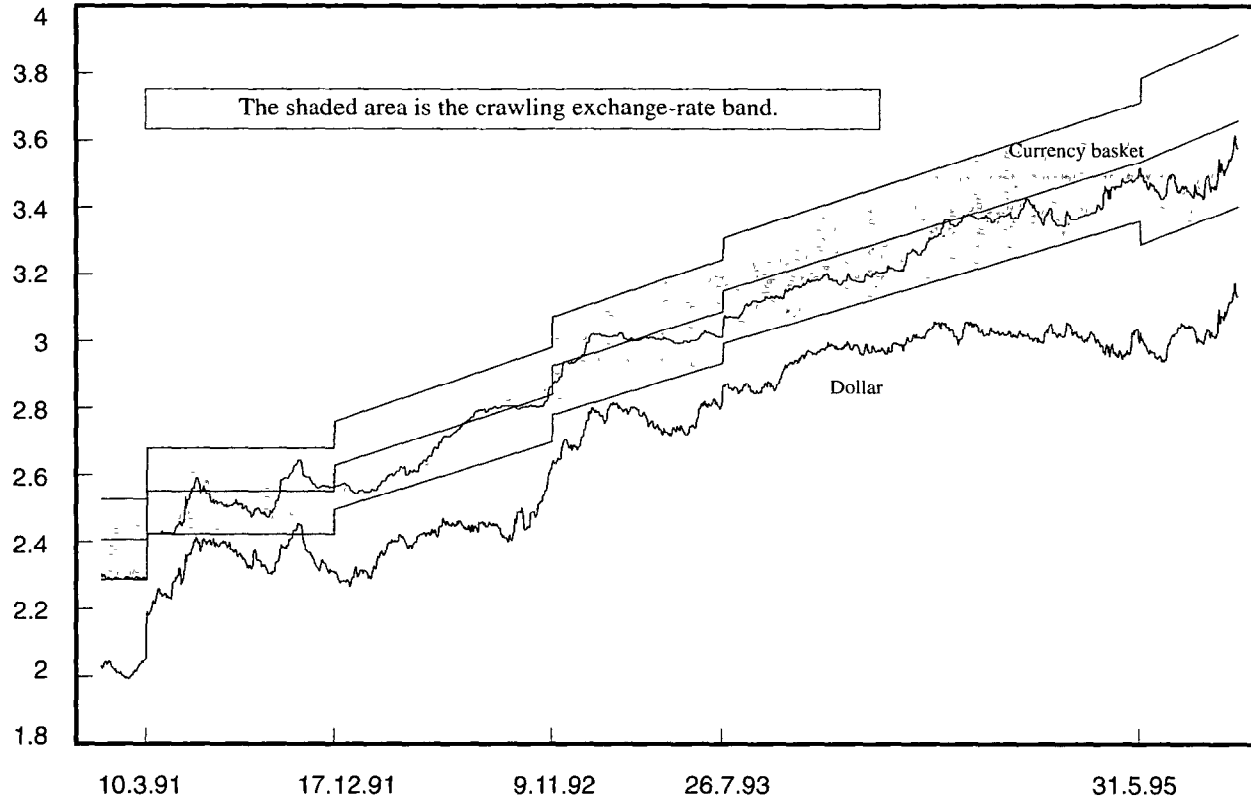
	(percent)									
	1980	1986	1988	1989	1990	1991	1992	1993	1994	1995
<b>Average tax rate on</b>										
Total imports	9	1	16	11	11	11	12	11	9	8.5
Consumer goods	20	25	24	23	22	22	24	20.2	18	18.0
durables	110	96	99	74	69	67	67	63.4	59.8	57.4
Intermediates	5	7	5	4	4	4	4	3.1	2	1.7
Producer durables										
Machinery and equipment	11	11	10	10	8	7	8	6.6	3.9	3.1
Motor vehicles	39	83	73	64	65	54	59	54.5	52.9	50
<b>Change in average tax rate on total imports, due to</b>										
Tax rates		1.7	-4.4	-4.0	-0.8	-1.5	-0.2	-0.8	-2.4	-1.2
Composition of imports		5.3	4.4	-1.0	0.8	1.5	1.2	-0.2	0.4	0.7
<b>Average effective exchange rate</b>										
of all imports		1.72	1.86	2.13	2.24	2.55	2.77	3.14	3.31	3.28
<b>Standard deviation of effective exchange rates</b>										
		0.24	0.26	0.20	0.21	0.22	0.23	0.22	0.22	0.21

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

SOURCE: Based on Central Bureau of Statistics data.



**Figure 6.2**  
**The Sheqel Exchange Rate Against the Currency Basket and the Dollar, 1991-95<sup>a</sup>**



<sup>a</sup> Weekly data (Mondays), in NIS per \$ or NIS per currency-basket unit.

those from other sources. This development also arose from the abolition at the beginning of 1995 of all tariffs on imports from the US, as part of the trade agreement between the two countries.

The implementation of liberalization began in late 1991, its intention being to expose Israel to imports from countries with which it has no trade agreements. This helps to make the economy more efficient and leads it to specialize in areas in which it has a comparative advantage, thereby stimulating both growth and exports. It also helps to prevent trade from being diverted to expensive sources of imports, acts as a brake on price increases, and widens the variety available to consumers. The highest growth rates in 1995 were in imports from Asia and East Europe. Although these expanded at a slower rate than in 1994, they outstripped imports as a whole. In 1990, the year before liberalization began, imports from Asia (excluding Japan) constituted 3.4 percent of all merchandise imports, and those from East Europe 1.6 percent. By 1995 these had expanded to 7.0 percent and 3.2 percent respectively, providing proof of the partial success of the liberalization program. The increase in imports from these sources is also connected with political developments in the Middle East and East Europe. Some of the success takes the form of domestic producers' improved efficiency in the face of the threat of imports, rather than of increased imports.

One of the factors hindering liberalization is Israel's centralization of imports. In some cases an importer is granted the exclusive concession for a brand, and in others one firm is the sole importer of several competing brands, both instances serving to eliminate competition. In the food industry it is common for a domestic producer to import competing goods, again neutralizing competition against his own goods. Domestic producers also make agreements with international companies, the sole purpose of which is to prevent them from entering the domestic market.

### **The services account**

In 1995 there was a \$400 million export surplus on the services account.<sup>5</sup> After two years in which the surplus had contracted, it expanded again, reflecting a considerable fall in the rate of growth of the volume of imports and an increase in that of exports. Prices of imported services increased more than twice as fast as those of exported services (Table 6.3). Services exports contributed about 40 percent of the nominal growth of total exports (excluding capital), compared with 25 percent in 1994.

Imported tourist services account for more than a third of imported services,<sup>5</sup> and represent the expenditure of Israeli tourists abroad. In 1995 they expanded by a nominal 21 percent, less than the annual rate of increase in 1993–94.

A third of the increase in imported services arises from a 15 percent rise in the 'Other imported services' category. This item includes wages paid to foreign workers (not from the Autonomy or the administered areas), and provides an estimate of the direct costs of such employment, without taking its externalities into consideration.

<sup>5</sup> Excluding capital, the Autonomy, and the administered areas.

Most foreign workers are employed in construction, and some in the tradable goods sector (agriculture and industry). This import of labor services is a partial substitute for goods imports. It enables agriculture and industry to continue to rely on cheap labor, instead of introducing technological improvements.

Exports of tourist services at current prices grew by 21 percent in 1995. Expenditure per tourist in 1995 increased, after falling in 1994. The average stay per tourist lengthened. A 14 percent rise in the number of tourists from the US—compared with a 1 percent increase in 1994—contributed to these developments, despite the dollar's weakness which makes imports into the US more expensive. On average, a tourist from the US spends more money in Israel than do other tourists.

### **Capital services**

In 1995, for the first time in several years, the import surplus on capital services fell—a surprising development in light of the extent of capital inflow. Although the import of these services rose by 15 percent in 1995, following a 14 percent increase in 1994, capital services exports surged by 55 percent after falling steadily in recent years. Two of the reasons for the rise in these exports were apparently temporary, i.e., the growth of the foreign-exchange reserves and the increase in world interest rates on short-term dollar deposits (annual average). These interest rates started declining during 1995. The import of capital services is expected to increase in 1996, when interest payments on loans received under the US government guarantees will begin.

### **Unilateral transfers**

Net unilateral transfers were \$0.1 billion higher than in 1994. The import surplus rose much faster than these transfers, which therefore financed only 63 percent of the import surplus, some 10 percentage points less than in 1994.

Transfers to the public sector fell, continuing the trend prevailing since 1992. This may be due in part to the decline in defense imports in 1995. In contrast, transfers to the private sector continued expanding. This is partly due to the continued rise in restitutions payments from Germany, most of which is the result of the dollar's weakness against the DM. Most of the increase in private-sector transfers were private cash transfers, some of which may have been short-term capital movements related to the interest-rate spread between Israel and abroad. The development of these cash transfers seems to be correlated with reported short-term capital movements.

### 3. THE CAPITAL ACCOUNT

#### *Capital flows: financing the current-account deficit and the change in the reserves*

The deficit on the current account was financed in 1995 by capital inflow in all sectors—private nonfinancial, banking, and public—and all categories of capital flows. The current-account deficit of the nonfinancial private sector was also financed by capital inflows and by domestic foreign-currency sources of the commercial banks. Some of these sources reflected the withdrawal of deposits from the Bank of Israel—the result of the continued gradual reduction of the reserve requirement on foreign-currency deposits (restitutions deposits) and the lower rate of interest paid by the Bank of Israel on the banks' other foreign-currency deposits. Other foreign-currency sources made available to the nonfinancial private sector can be traced to dollar balances accumulated by the commercial banks since August 1995 by means of swap transactions with the Bank of Israel, to foreign-currency deposits of money borrowed under the US government guarantees, earmarked for credit to the business sector.

Capital inflow, which in 1995 exceeded the amount required to finance the current-account deficit, continued throughout the year. Thus—in contrast with the recent past—the deficit was not financed at the expense of the foreign-currency reserves, and these actually increased. The rise in the reserves masked the seriousness of the deficit on the current account. The partial financing of the deficit by means of the import of short-term capital and the significant accumulation of foreign-currency liabilities and local-currency assets by the nonfinancial private sector are incompatible with a stable exchange rate, however. It is therefore necessary to correct the deviation from the government's target budget deficit, despite the economy's greater ability to bear the burden of the current-account deficit. This improvement is indicated by such measures as the ratio of external debt to GDP and to exports, which fell, the number of import months covered by the reserves, Israel's improved rating in the international financial markets, the rate of economic growth, and the inflow of long-term capital, which is not related to the interest-rate differential between Israel and abroad.

In 1995, implied capital imports—the difference between the current-account financing requirements and the change in the reserves—rose significantly from their level in 1993–94, and reached some \$5.2 billion. Errors and omissions also grew substantially, to \$2.2 billion.<sup>6</sup>

Capital inflow was reflected by foreign-currency conversions by the public, as a result of the Bank of Israel's intervention in the foreign-currency market—intended to moderate local-currency appreciation. Thus the exchange rate rose, and in the

<sup>6</sup> This item measures the difference between the amount required to finance the deficit on the current account and recorded capital inflow and the change in the reserves. Errors and omissions are therefore included in implied private capital imports, but do not necessarily reflect unreported capital imports. For example, if the errors and omissions are due to inaccurate recording, making the current-account deficit appear larger than it actually was, implied capital imports will be an overestimate. Nonetheless, a substantial part of errors and omissions are considered to reflect unreported capital flows.

**Table 6.8****Long- and Medium-Term Loans, 1991-95<sup>a</sup>**

	(\$ million at current prices)				
	1991	1992	1993	1994	1995
<b>1. Total receipts</b>	<b>2,777</b>	<b>2,395</b>	<b>3,963</b>	<b>4,804</b>	<b>3,138</b>
a. Public sector	1,712	1,775	3,286	3,630	2,184
State of Israel Bonds	966	1,197	1,164	1,123	1,054
Bonds guaranteed by US government	400	0	2,010	2,402 <sup>b</sup>	753
US government loans	0	0	0	0	0
Other foreign governments	237	359	82	87	98
Other government loans	109	219	30	18	280
b. Nonfinancial private sector	1,064	620	677	1,174	953
<b>2. Total repayment</b>	<b>2,217</b>	<b>1,882</b>	<b>1,925</b>	<b>2,224</b>	<b>2,219</b>
a. Public sector	1,046	1,110	1,265	1,560	1,513
State of Israel Bonds	401	435	516	706	641
Bonds guaranteed by US government	170	212	244	270	282
US government loans	233	236	235	248	243
Other foreign governments	112	140	140	145	174
Other government loans	130	87	131	191	173
b. Nonfinancial private sector	1,171	771	660	664	706
<b>3. Total net receipts</b>	<b>560</b>	<b>513</b>	<b>2,038</b>	<b>2,580</b>	<b>918</b>
a. Public sector	666	664	2,021	2,069	672
State of Israel Bonds	565	761	648	417	413
Bonds guaranteed by US government	230	-212	1,766	2,132	471
US government loans	-233	-236	-235	-248	-243
Other foreign governments	125	219	-58	-58	-76
Other government loans	-21	132	-101	-173	107
b. Nonfinancial private sector	-106	-151	17	510	247

<sup>a</sup> Excluding loans of the banking sector. Figures may not add due to rounding.

<sup>b</sup> Including \$ 80 million, replacement of old debt by bonds guaranteed by US government.

SOURCE: Based on Central Bureau of Statistics data.

second quarter reached the midpoint rate of the crawling band. The interest-rate differential between local- and foreign-currency assets (credit) in the second half of the year had reached a similar level in the past unaccompanied by significant capital inflow. The continued capital inflow in July–December—reflecting yield (cost) differentials—therefore mainly reflects a moderation of expectations of depreciation. This was supported by the implementation of a more flexible intervention policy in the foreign-exchange market by the Bank of Israel, made possible after the crawling band had been widened in June 1995 by 2 percentage points on either side of the midpoint.<sup>7</sup> Nonetheless, the actual change in the exchange rate was not enough to offset capital

<sup>7</sup> At the same time the band was moved upwards by 0.8 percentage points, in order to offset the effects of changes in the structure of port fees and tariffs paid by importers and exporters, and the weight of the US\$ in the currency basket was increased by 3.2 percentage points.

flows; capital import persisted, and currency conversions by the nonfinancial private sector in 1995 reached \$6.2 billion, \$2.4 billion of which in the second half of the year.

The Bank of Israel's tight monetary policy, alongside its prevention of the appreciation of the NIS to the level which would have balanced the foreign-exchange market, were reflected by the sterilization of the expansionary effect of the conversions. This was achieved by reducing the monetary loan, engaging in open-market sales of Treasury bills, and introducing swap transactions of foreign currency against local currency with the banks.

In the second half of December there was demand for foreign currency; the exchange rate went up at an accelerated pace—after rising moderately in October and November—and approached the midpoint rate. During the year the NIS depreciated against the dollar and the currency basket by 3.1 percent and 5.8 percent respectively (Figure 6.2). Most of the rise in the exchange rate took place in the last quarter, when depreciation against the dollar and the currency basket was 4.7 percent and 3.9 percent respectively. It seems that the rise in the exchange rate at the end of the year mainly reflected expectations of a reduction in interest, in light of expected budget cuts at the beginning of 1996. When it became clear that the cuts fell short of expectations, however, capital inflow, conversions, and local-currency appreciation resumed.

Reported imports of long-term capital fell in 1995, and on the basic account (the current account *less* long-term capital movements) there was a deficit of about \$1.9 billion, in contrast with the surplus of previous years (Table 6.2). This deficit means that a significant share of the current account was financed by the inflow of short-term capital, a fact which drives home the importance of reducing the current-account deficit.

Imports of long-term capital fell in 1995 as a result of the reduction in net capital import by the government, since that of the nonfinancial private sector expanded considerably. In 1995, by contrast with 1993–94, the government did not utilize the annual quota of bonds issues under the guarantee arrangement with the US government. Instead, towards the end of the year it borrowed from abroad via a consortium of foreign banks and by issuing bonds not covered by US guarantees, apparently as a preparatory step towards the post-guarantee period. The gap between the government's foreign borrowing in 1994 and 1995 reflects the early utilization of some \$750 million of the 1995 guarantees, without which public-sector borrowing would have been the same in both years.

The increase in reported imports of medium- and long-term capital by the nonfinancial private sector (Table 6.2) reflects a rise in net investment in Israel by nonresidents (Table 6.10), as long-term loans show a small net capital inflow (Table 6.8). These investments reflected mainly changes in company or real estate ownership (direct investment) between Israeli investors and nonresidents, and financial investments, which in 1995 included repatriation of overseas investments by residents and (net) investment by nonresidents in securities on the TASE (Tel Aviv Stock Exchange). Net direct investments arise from long-term profitability considerations, and hence do not depend

**Table 6.9**  
**Balance of Payments, by Sector, 1991-95<sup>a</sup>**

	(\$ million, at current prices)				
	1991	1992	1993	1994	1995
<b>Public sector</b>					
Current account	1,540	1,731	669	419	361
Capital movements	666	664	2,021	2,069	672
Basic account	2,206	2,396	2,690	2,488	1,032
Short-term capital imports	0	-4	-7	-79	-1,210
Capital movements via banking system	196	-26	-1,906	836	-268
Errors and omissions	-327	332	1,367	-1,769	-374
Effect on foreign reserves <sup>b</sup>	-2,075	-2,698	-2,144	-1,477	820
<b>Private sector</b>					
Current account	-2,185	-1,605	-1,669	-2,795	-4,414
Medium- and long-term capital movements	-509	-1,225	131	638	1,559
Basic account	-2,694	-2,830	-1,538	-2,157	-2,855
Short-term capital imports	466	-125	-567	-104	995
Capital movements via banking system	-566	-1,033	2,429	-2,066	1,305
Errors and omissions	547	78	-988	2,919	2,524
Effect on foreign reserves <sup>b</sup>	2,248	3,911	664	1,407	-1,968
Implied private capital imports	-63	-2,306	1,005	1,388	6,382

<sup>a</sup> Figures may not add due to rounding. Public sector current account differs from the one in Table 6.2 due to an adjustment arising from advance defense payments.

<sup>b</sup> A negative figure indicates an increase in the reserves.

SOURCE: Based on Central Bureau of Statistics data.

on short-term yield differentials. Despite the expansion of these investments, in 1995 they constituted only some 19 percent of the net sources required to finance the current-account deficit. Their total—\$780 million—was also modest relative to the \$10.5 billion of foreign-currency sources available to the nonfinancial private sector (assuming that the current-account deficit is measured correctly). Of these sources, \$3.7 billion represent short-term credit from the domestic banks, and \$1 billion direct short-term capital imports. For the first time since liberalization of the capital market began, foreign direct investments in Israel exceeded investment abroad by Israelis. This reflects Israel's improved international image, due *inter alia* to continued economic growth and progress in the peace process, which reduced the country-risk factor associated with direct investment in Israel. Nonetheless, a substantial share of foreign investment was financed by domestic banks, so that both net capital inflow arising from these investments and the exposure of nonresidents to the risks of direct investment in Israel were lower than might be assumed *prima facie*.

As stated, the nonfinancial private sector imported short-term capital in 1995, as it became more worthwhile to take foreign-currency credit. For the same reason, the

demand for foreign-currency—mainly dollar—credit from domestic banks rose too. The banks imported some \$1 billion which, together with domestic foreign-currency sources, financed this credit.

Despite unprecedented currency conversions, the reserves expanded by only \$1.5 billion during 1995, because of withdrawals of foreign-currency deposits by the banks and the government to provide credit to the nonfinancial private sector. At the end of 1995 the reserves reached \$8.7 billion, and the number of import months covered by them rose. The deficit on the current account was reflected by a rise in the external debt. The external debt/GDP ratio fell, however (Table 6.1), as GDP expanded considerably, and product prices increased faster than the dollar exchange rate during the year. The external debt/exports ratio also indicated a decline. Debt calculations, however, are based on recorded debt only, and in the context of the considerable deficit on the current account and the capital inflow, it is reasonable to assume that the actual rise in the external debt was more substantial.

\* \* \*

The current-account deficit creates external debt, and to allow the servicing of the debt, output must grow. The rate of growth needed to maintain the external debt/GDP in view of the accrued debt arising from the current level of deficit—is exceptionally high, and is not sustainable. Thus it seems that the current-account deficit cannot long sustain its present course, and corrective—essentially fiscal—measures must be taken. The question still remains as to how the authorities will cope if and when the present trend of capital inflow is reversed. In such a case, the Bank of Israel has sufficient instruments available to cope with capital outflow for a certain period. There are many indicators, as mentioned above, which suggest that the economy is well able to bear the burden of the deficit on the current account (Table 6.1). Moreover, the Bank of Israel can also attract foreign-currency bank deposits by raising the interest it pays on them.<sup>8</sup>

Bearing in mind continued economic growth and the achievement of the inflation target in 1995, the probability of a surge of foreign-currency purchases is low, although financial developments and deficits on the current account and in the budget indicate deterioration in this respect. Unless there is a dramatic improvement regarding the current-account deficit, the situation will worsen. Any improvement is contingent upon correction of the deviation from the planned budget deficit path, and second, continued reduction of the budget deficit. In the absence of fiscal restraint, however, the continued deviation of the exchange rate from the midpoint rate of the crawling band, and the

<sup>8</sup> The experience of other countries which have fully liberalized the capital account of the balance of payments is very instructive. In Sweden for instance, short-term interest soared from an annual 11.5 percent at the beginning of July 1992 to some 500 percent in September that year. In November the authorities had to float the exchange rate, and devalue the local currency. Following the implementation of fiscal restraint, short-term interest rates fell, but remained high until the exchange rate was allowed to float completely freely.



<b>Table 6.10</b> <b>Investment in Israel by Nonresidents, and Investment Abroad by Residents, 1991-95</b>					
	(\$ million, at current prices) <sup>a</sup>				
	1991	1992	1993	1994	1995
<b>1. Investment by nonresidents</b>	<b>587</b>	<b>1,231</b>	<b>5,707</b>	<b>1,642</b>	<b>3,705</b>
Traded securities in TASE	103	387	4,847	991	1,819
Direct Investment	508	824	841	623	1,861
State of Israel Bonds <sup>b</sup>	1	3	2	0	0
Merchandise	-44	-11	-8	-9	-12
Reinvestment of profits	19	28	26	36	37
<b>2. Repatriation of investment by nonresidents</b>	<b>221</b>	<b>727</b>	<b>4,951</b>	<b>1,038</b>	<b>1,675</b>
Investment in traded securities	88	422	4,671	808	1,426
Direct investment	134	305	281	230	249
<b>3. Net investment by nonresidents</b>	<b>366</b>	<b>504</b>	<b>756</b>	<b>604</b>	<b>2,030</b>
Investment in traded securities, net	15	-35	176	183	393
Direct investment, net	375	519	560	393	1,611
<b>4. Investment abroad by residents</b>	<b>1,355</b>	<b>2,087</b>	<b>2,786</b>	<b>1,544</b>	<b>1,565</b>
Investment in traded securities	926	1,424	2,039	737	648
Direct investment	428	663	747	807	917
<b>5. Repatriation of investment abroad by residents</b>	<b>586</b>	<b>510</b>	<b>2,144</b>	<b>1,068</b>	<b>847</b>
Investment in traded securities	581	497	2,118	1,039	761
Direct investment	5	13	26	29	86
<b>6. Net investment abroad by residents</b>	<b>769</b>	<b>1,577</b>	<b>641</b>	<b>476</b>	<b>718</b>
Investment in traded securities, net	345	926	-79	-302	-113
Direct investment, net	423	651	721	778	831
<b>7. Net investment from abroad by individuals (3-6)</b>	<b>-403</b>	<b>-1,073</b>	<b>114</b>	<b>128</b>	<b>1,312</b>
Investment in traded securities, net	-330	-961	255	485	506
Direct investment, net	-49	-132	-160	-385	781
<b>8. Foreign securities held by banks<sup>c</sup></b>	<b>-83</b>	<b>341</b>	<b>809</b>	<b>569</b>	<b>-122</b>
<b>9. Total net investment from abroad (7-8)</b>	<b>-320</b>	<b>-1,414</b>	<b>-695</b>	<b>-442</b>	<b>1,433</b>
<sup>a</sup> Figures may not add due to rounding.					
<sup>b</sup> Redemption of independence and development bonds for investment.					
<sup>c</sup> Includes investment abroad by banks.					
SOURCE: Based on Central Bureau of Statistics data.					

accumulation of foreign-currency liabilities and liquid local-currency assets by the nonfinancial private sector could reverse the capital inflow, undermining the Bank's credibility, and creating expectations of a rise in the exchange rate. Such expectations are likely to be reflected by a steep rise in the exchange rate in reaction to market forces, a deviation from the inflation target, a reduction in the reserves, and a rise in the interest rates confronting Israel in the world market. In such situations domestic interest can also rise significantly, as in part it reflects a premium for expected local-currency depreciation in a relatively short period of time, i.e., a high premium in annual terms.<sup>9</sup>

In 1995, short-term foreign-currency credit taken by the nonfinancial private sector grew significantly. Total outstanding short-term foreign-currency credit from the domestic banks reached \$8.1 billion at the end of the year, and the ratio of this credit to the reserves rose from 50 percent at the end of 1994 to 85 percent a year later.<sup>10</sup> The growth of credit may be viewed as an adjustment of the composition of the public's wealth in reaction to a change in expectations and higher local-currency interest rates. It may also be seen, however, as a potential source of foreign-currency purchases intended to reduce foreign-exchange exposure when foreign-currency credit is expected to become more expensive in local-currency terms. Alongside the considerable rise in short-term foreign-currency credit, local-currency liquid assets, including interest-bearing deposits up to three months, grew too. The stock of these assets rose, reaching some \$10 billion by the end of the year.<sup>11</sup> This is another indication of the potential pressure, mentioned above, on the foreign-exchange reserves or the government's lines of credit, which should also include the financing requirements of the current-account deficit. Against this potential pressure stand the reserves—which reached \$9.9 billion in February 1996—and another \$5 billion from the balance of the US guarantees.<sup>12</sup>

The deficit on the current account, together with the financial developments described above, emphasize the urgent need for policy—mainly fiscal—measures to reduce the deficit.

### *Monetary policy, capital movements, and the exchange rate*

At the end of 1994 the Bank of Israel adopted a tight monetary policy—with higher interest and yields (costs) on local-currency than on foreign currency—which was the prime cause of the capital inflow. The yield (capital cost) differentials are in general affected by expectations of exchange-rate changes and differentials between local- and foreign-currency interest rates. In the second half of 1995 expected yield differentials, based on the assumption that the exchange rate would revert to the midpoint within a

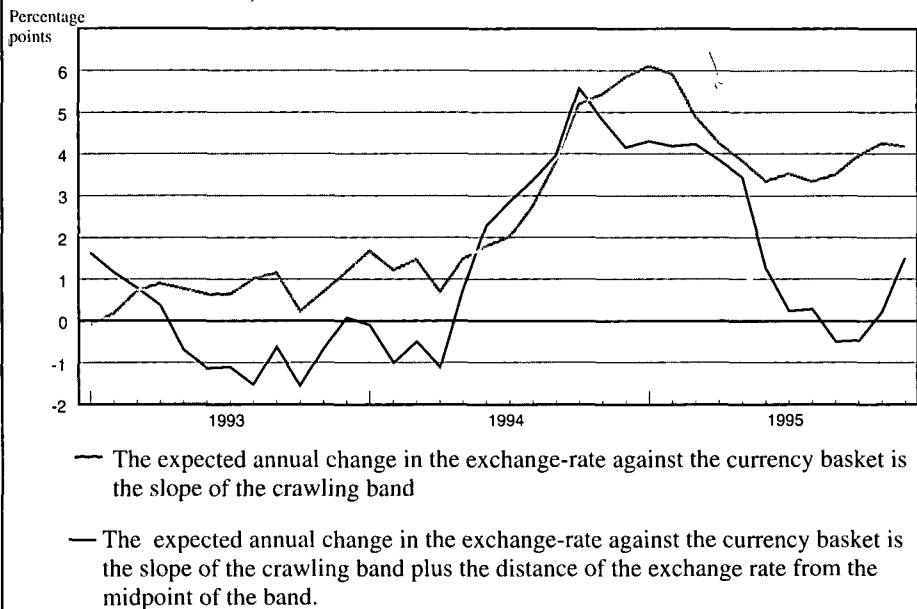
<sup>9</sup> Although experience has shown that the Bank of Israel succeeded in attracting foreign-currency deposits by paying a low interest premium, these deposits have hitherto not exceeded \$ 2.5 billion, and at present the cost of attracting larger deposits is not clear.

<sup>10</sup> This represents an underestimate of short-term foreign-currency credit, as it does not include direct credit from abroad, or unreported short-term credit.

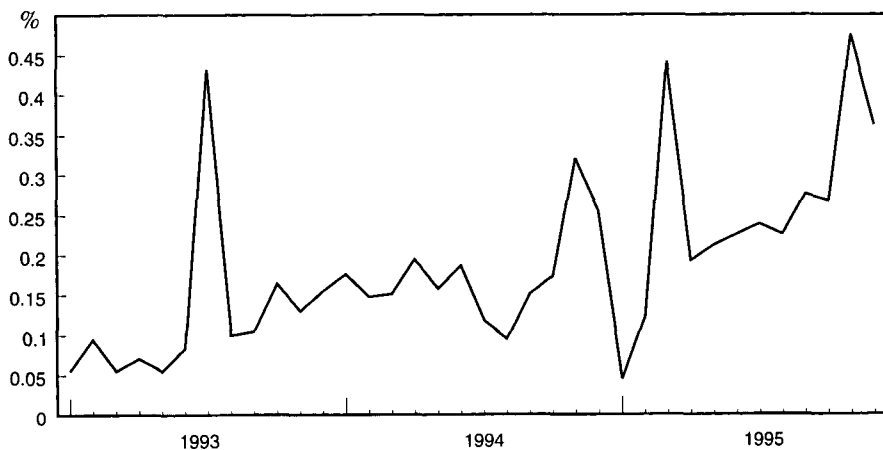
<sup>11</sup> Evaluated at the upper limit of the exchange-rate band.

<sup>12</sup> Note that since 1983 the reserves have never fallen below two import months.

**Figure 6.3**  
**The Interest Rate Differential between Domestic and Foreign-Currency**  
**3-Month Credit, 1993-95**

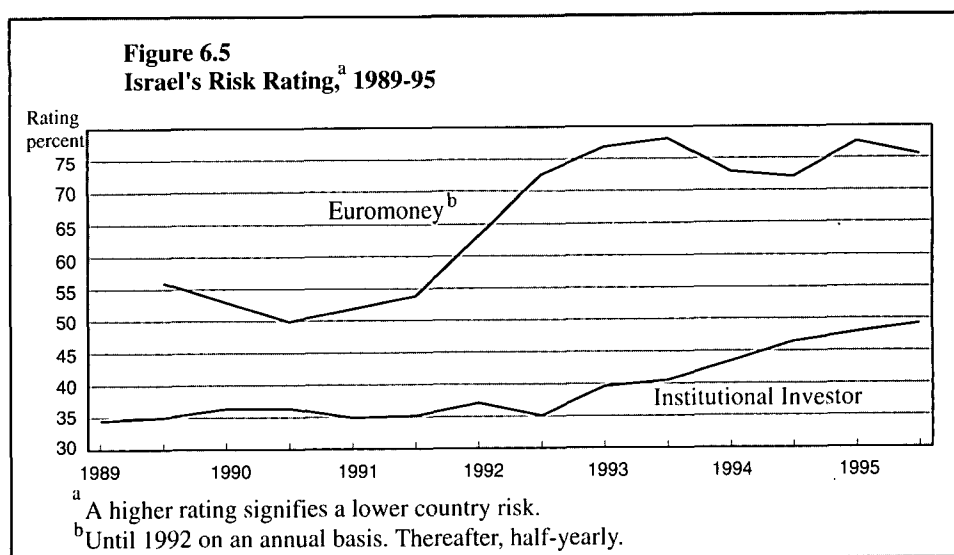


**Figure 6.4**  
**Monthly Standard Deviation of the Rate of Change of the Exchange Rate,**  
**1993-95**



SOURCE: Bank of Israel.

year, apparently contracted to what they had been in July–November 1994 (Figure 6.3), just before the capital inflow began. However, while from July to November 1994 purchases amounted to some \$40 million a month, and sources of foreign currency available to the nonfinancial private sector were only \$680 million per quarter, in the second half of 1995, conversions of foreign currency by the nonfinancial private sector stood at some \$400 million a month, while its sources of foreign currency averaged \$2.5 billion per quarter. These figures indicate that between the two periods expected local-currency yields (costs) rose relative to those of foreign currency.



Yield differentials may also arise from changes in foreign-exchange and country-risk premiums. The former, as measured by the variance of the daily rate of change of the exchange rate, actually rose (Figure 6.4). The reduction of Israel's country risk began in the early 1990s, and cannot be regarded as the cause of the change which occurred in the second half of 1995. Hence, after June 1995 expectations of a rise in the exchange rate were lower than those derived from the position of the exchange rate within the crawling band, or at least, lower than they had been hitherto.

Moderate expectations of a rise in the exchange rate in the second half of 1995 were caused by the public's assessment of the central bank's policy. In the context of the Bank of Israel's determination to prevent inflation from accelerating by raising local-currency interest rates and widening the exchange-rate band, alongside a declaration<sup>13</sup> of its intention to allow greater flexibility in the determination of the exchange rate in

<sup>13</sup> In a press release from the Ministry of Finance and the Bank of Israel dated 31.5.95.

response to market forces, the public assessed that the central bank would reduce its intervention in the foreign-exchange market. This was to be achieved by utilizing more fully the width of the exchange-rate band, and indeed, during the second half of 1995 the NIS depreciated more slowly than the rate to which the public had been accustomed till then; in some months there was actually local-currency appreciation. Since mid-1992, the exchange-rate fluctuated mainly within a range of up to 2 percent above the midpoint and 3 percent below it, whereas in the third quarter of 1995, after the band was widened by 2 percent on each side of the midpoint, the exchange rate fell as low as 4.5 percent below it. Nevertheless, the minimal distance of the exchange rate from its lower boundary was not allowed to change as a result of the widening of the band. The Bank of Israel's determination to follow its high interest-rate policy contributed to capital inflow not only through the rise in interest-rate differentials, but also by affecting the public's perception of persistence with which the policy would be implemented. If the public is convinced that monetary restraint will persist, it will regard the reversal of interest differentials as less likely. Hence, the period in which the public may benefit from existing interest-rate differentials is extended, the share of fixed costs in capital import transactions contracts, and these transactions become more worthwhile.

### *Country risk*

The fall in Israel's country risk—based on geopolitical developments and its impressive economic achievements in the last five years—persisted and even intensified in 1995. For the first time since the start of the liberalization of capital movements, direct foreign investment in Israel exceeded direct Israeli investment abroad. Israel's lower country risk was indicated by significant foreign investment in government dollar-indexed bonds, at a floating interest rate which is reset every six months according to changes in dollar interest in world markets. Foreign holdings of these bonds, including capital gains, leapt from \$14 million at the end of 1994 to \$140 million a year later.<sup>14</sup> As these bonds are foreign-currency-indexed, the only factor which makes them more attractive to foreign investors is a reduction of country risk. Another indication of Israel's relatively good standing in international capital markets is the fact that the spread between the new bond issue outside the guarantee arrangement and the parallel interest on US government bonds did not greatly exceed that between the issue under the guarantees and the latter. The reduced premium paid over and beyond the interest on US T-bills at the beginning of 1996 on State of Israel Bonds, and the favorable terms the government obtained in raising the first loan in 1996 under the guarantee arrangement also point in the same direction. These assessments regarding Israel's reduced country risk are also expressed by comparative risk ratings (Figure 6.5) which show a significant improvement in Israel's standing in international markets since the beginning of the 1990s.

<sup>14</sup> Source: Bank of Israel, Foreign-Exchange Control Department.

## Capital flows

This section relates only to reported capital flows. Since the beginning of the liberalization of capital flows, a considerable number of capital movements are either not reported at all, or are reported with a delay, and are therefore in effect included in the errors and omissions item. It is not clear, however, how to divide this item between capital flows and errors in measuring the current-account deficit. Hence, the discussion will be based mainly on reported capital movements. In any event, the problem of recording on the current account does not contradict the assessment that a large part of errors and omissions reflects unreported capital movements.

### *The public sector*

Total net public-sector capital movements in 1995 resulted in capital outflow of about \$500 million, compared with inflows of \$2.1 billion and \$2.3 billion in 1994 and 1993 respectively. This was due to lower imports of long- and medium-term than in 1993–94, and more substantial exports of short-term capital (some \$1.2 billion) than in both 1994 when there were negligible short-term capital imports, and 1993, when they amounted to about \$260 million (Table 6.2).

Exports of short-term capital consisted of a \$230 million net increase in foreign assets, and \$950 million reflecting an accounting entry intended to balance the recording of the full amount of US economic aid in the unilateral transfers item, even though this aid was not received until February 1996. According to the double-entry accounting system, the public sector was credited with this amount, and at the same time a debit was shown in the short-term capital exports item, as if the share of the aid which was delayed was a credit granted to the US government. Ignoring this effect of the double-entry system, public-sector capital movements showed net imports of \$450 million.

The difference between long- and medium-term capital imports in 1994 and 1995 reflects essentially the fall in gross borrowing, as public-sector repayments of long-term loans in both years were at an annual level of about \$1.5 billion (Table 6.8). Total borrowing amounted to \$2.2 billion in 1995, compared with \$3.6 billion in 1994. Net long- and medium-term capital imports totaled \$670 million, down from \$2.1 billion in 1994. After adjusting for the \$750 million loan in the framework of the guarantees brought forward from 1995 to the end of 1994, gross borrowing remained unchanged, although \$750 million of the 1995 guarantee loans was not utilized because money was borrowed from other sources rather than under the guarantees. In the course of 1995 some \$530 million was borrowed from new sources, \$250 million of it through the flotation of negotiable 10-year bonds outside the US government guarantees, and \$275 million via a consortium of foreign banks for periods between two and a half and five years. This action by the government makes economic sense, as it paves the way for borrowing on international markets once the guarantees have been fully utilized, avoiding the need to borrow at relatively high cost.

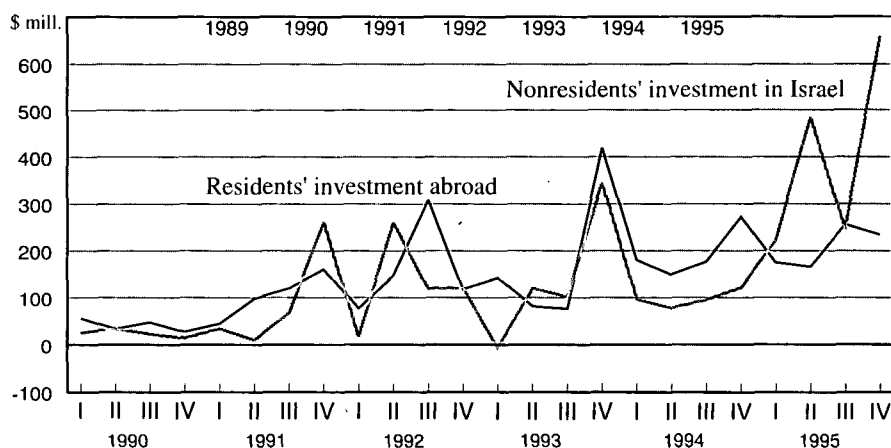
In 1995 the public sector's contribution to the reserves was a negative \$820 million, mainly reflecting the utilization of money under the guarantees to provide credit to the business sector (Table 6.9).

Towards the end of 1995—in view of the removal by the US government of the restrictions on the uses of the guarantee money, and the lower cost of foreign- than local-currency credit—the government began to finance the domestic deficit by means of foreign-currency conversions. At the same time direct borrowing on the domestic market fell. From the point of view of the government alone, this step made the financing of the budget deficit cheaper than direct borrowing in the domestic capital market, but does not allow for the *ex post* financing costs of the consolidated public sector. The *ex post* composition of public-sector deficit financing does not result from the government's policy alone, but from that of the Bank of Israel and from the conduct of the business sector. In the absence of capital imports, the government's conversions of foreign currency could have served to finance the current account deficit of the nonfinancial private sector. However, due to capital inflow in 1995, and the Bank of Israel's intention of keeping interest high, the government's conversions were sterilized, leading to an increase in the internal debt. The government's overseas borrowing raised the gross external debt, but against this the Bank of Israel's foreign-exchange reserves grew, so that the net external debt did not increase. Thus, *ex post*, the consolidated public-sector deficit was financed by an increase in the internal and not the external debt. From the point of view of the consolidated sector, this method of deficit financing is more expensive than direct borrowing in the domestic capital market. This is due to the fact that financing costs in this case include the difference between the interest on the incremental gross external debt and the lower interest received on the incremental reserves.

#### *The nonfinancial private sector*

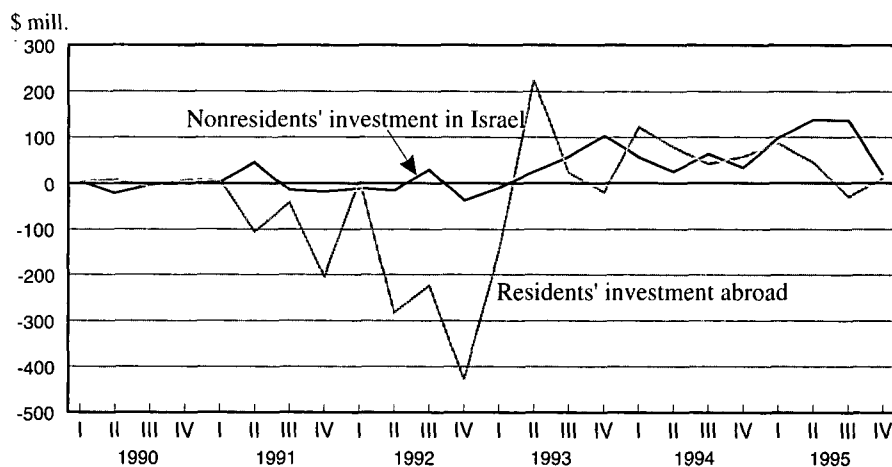
*A. Long- and medium-term flows:* Long- and medium-term net capital imports by the nonfinancial private sector in 1995 totaled \$1.6 billion, up from \$640 million in 1994 (Table 6.2). Its main components were direct loans from overseas, which amounted to \$250 million (Table 6.8), direct investment, and portfolio investment (about \$780 million and \$500 million net respectively, Table 6.10). In 1994, by contrast, capital imports consisted mainly of credit from abroad, of about \$500 million, whereas direct and portfolio investment together totaled only \$130 million. The reason was that in 1994 a substantial share of foreign direct and portfolio investment in Israel—about \$600 million—was offset by similar (net) investments abroad by residents (\$480 million). The exceptional extent of loans in 1994 reflects mainly large loans (about \$560 million) taken by leading Israeli companies unable to obtain such loans from domestic banks because of regulations preventing a domestic bank from lending more than 15 percent of its equity to a single borrower.

**Figure 6.6**  
**Net Direct Investment, 1990-95<sup>a</sup>**



<sup>a</sup> Quarterly data. For residents' investment abroad, positive values signify capital outflow and negative ones repatriation.  
SOURCE: Based on Central Bureau of Statistics data.

**Figure 6.7**  
**Net Investment in Securities, 1990-95<sup>a</sup>**



<sup>a</sup> Quarterly data.



**Table 6.11****Balance of Payments of the Private Sector, 1994-95**(\$ million, at current prices)<sup>a</sup>

	1994				1995			
	I	II	III	IV	I	II	III	IV
Current account <sup>b</sup>	-559	-1,026	-870	-340	-1,010	-805	-1,338	-1,261
Medium- and long-term capital movements	271	349	83	-65	338	510	116	594
Basic account	-288	-677	-787	-405	-672	-295	-1,222	-667
Short-term, capital imports	111	145	159	-520	182	344	201	268
Capital movements via the banking system	-2,227	78	-795	880	1,721	304	84	-805
Errors and omissions	1,998	244	640	37	526	315	760	923
Effect on foreign reserves <sup>c</sup>	406	210	783	8	-1,758	-669	178	281
Implied private capital imports	153	816	87	332	2,768	1,474	1,160	980
<b>Nonfinancial private sector</b>								
Current account	-576	-1,012	-868	-356	-789	-756	-1,347	-1,251
Effect on foreign reserves <sup>c</sup>	-268	64	126	-273	-2,105	-1,662	-1,279	-1,119
Foreign-currency sources <sup>d</sup>	844	948	743	629	3,094	2,418	2,626	2,371

<sup>a</sup> Figures may not add due to rounding.<sup>b</sup> Adjusted for transactions between the private and public sectors, and hence the difference from the figures in Table 6.2.<sup>c</sup> A negative figure indicates an increase in the reserves.<sup>d</sup> Nonfinancial private-sector capital import *plus* foreign-currency credit from domestic banks.

SOURCE: Based on Central Bureau of Statistics data

Direct investment in Israel which amounted to \$780 million in 1995 was the result of net foreign direct investment in Israel of an unprecedented \$1.6 billion, and net direct investment overseas of \$830 million by Israelis. This is the first time since 1991 that foreign direct investment in Israel has exceeded such investment abroad by Israelis (Figure 6.6). As mentioned above, this indicates a fundamental change in foreign investors' assessment of the profitability of investments in Israel, apparently the result of vigorous business activity in recent years, and of the political changes in the region, which have reduced their inherent risk. Of the total foreign direct investment in Israel, \$170 million was in real estate, and another \$800 million in domestic firms. Of the latter figure, some \$500 million was connected to transactions representing transfer to foreign ownership of shares (above 5 percent of equity) in leading Israeli companies (e.g., Koor, Israel Chemicals, and Bezeq). Thus, at least \$700 million of the total \$1.6 billion invested in Israel by nonresidents did not involve any real investment.

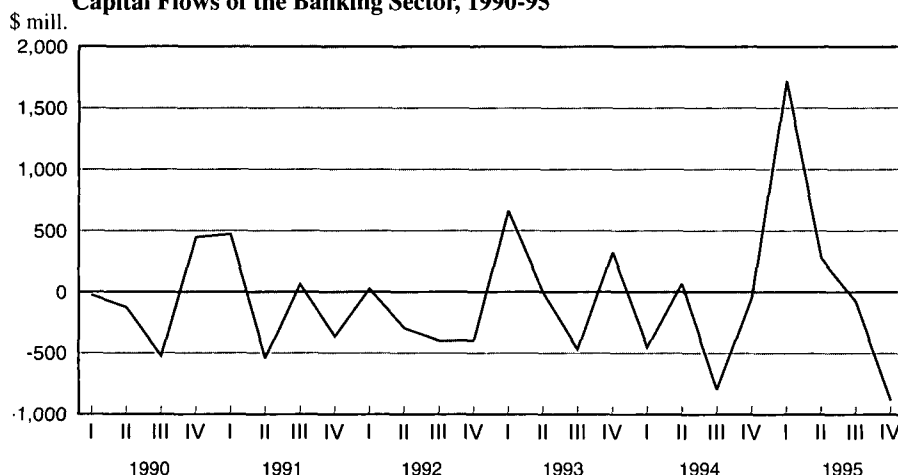
In addition to their direct investment in Israel, nonresidents invested some \$400 million (net) in securities traded on the TASE out of asset portfolio considerations. In contrast, Israeli investors in 1995 liquidated some of their portfolio investments on the TASE, as can be seen from data of the mutual funds which show net redemptions throughout the year. Liquidations and repatriation were also a feature of Israelis' overseas portfolio investments, contributing to a (net) capital inflow of about \$110 million and continuing the process evident since 1993 (Figure 6.7). Thus, capital inflow due to investments in securities in 1995 (not including securities of Israeli firms traded abroad) amounted to some \$500 million.

**B. Short-term flows:** Net imports of short-term capital by the nonfinancial private sector throughout 1995 totaled about \$1 billion, split equally between the first and second halves of the year (Table 6.11). This sum includes an increase of some \$330 million in short-term credit from abroad related to foreign trade—\$120 million (net) of foreign suppliers' credit to Israeli importers and the (net) repayment of \$210 million of credit extended to nonresidents by Israeli exporters. These forms of credit depend more on the extent of import and export transactions than on yield (cost) differentials between local and foreign currency. Similarly, the extent of flotations abroad by Israeli firms, some \$310 million—which are defined by the CBS as short-term capital imports—does not depend on such differentials either. Hence, out of a total short-term capital inflow of about \$1 billion in 1995, only some \$340 million may be considered as sensitive to the above yield differentials.

### *The banking system*

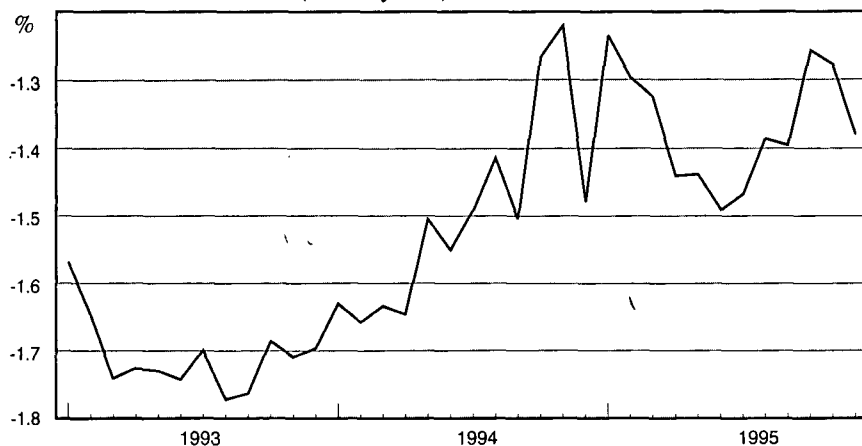
The banking system imported some \$1 billion of capital in 1995, reflecting net foreign-currency borrowing abroad, in order to finance *inter alia* an increase of \$3.7 billion in domestic short-term foreign-currency credit. Some of this increase was financed by an accumulation of foreign currency resulting from swap transactions with the Bank of Israel, and some by banks withdrawing foreign-currency deposits from it. Part of the

**Figure 6.8**  
**Capital Flows of the Banking Sector, 1990-95<sup>a</sup>**



<sup>a</sup> Quarterly data. Positive values signify capital inflow, and negative ones outflow.  
SOURCE: Based on Central Bureau of Statistics data.

**Figure 6.9**  
**The Spread Between LIBOR and the Cost of Domestic Foreign-Currency 3-Month Credit,<sup>a</sup> 1993-95**  
(Monthly data)



<sup>a</sup> LIBOR minus interest on domestic foreign-currency credit.

SOURCE: IFS and Bank of Israel.

**Table 6.12**  
**Assets and Liabilities in Foreign Currency, 1993-95<sup>a</sup>**

	(\$ million)		
	1993	1994	1995
<b>1. Gross liabilities<sup>b</sup></b>	<b>36,919</b>	<b>41,150</b>	<b>44,284</b>
a. Government	19,860	22,117	23,045
b. Nonfinancial private sector	4,488	5,172	5,891
c. Banking system	12,572	13,861	15,349
<b>2. Gross assets</b>	<b>20,093</b>	<b>23,430</b>	<b>25,067<sup>c</sup></b>
a. Bank of Israel reserves	6,384	6,795	8,158
b. Other financial institutions	669	542	530
c. Exporters' credit	2,578	2,967	2,757
d. Banking system	10,462	13,126	13,622
<b>3. Net external debt (1-2)</b>	<b>16,826</b>	<b>17,721</b>	<b>19,217</b>
<b>4. Total current external debt<sup>d</sup></b>	<b>3,611</b>	<b>3,951</b>	<b>4,547</b>
a. Nonfinancial private sector	1,743	1,889	2,285
b. Direct government debt	0	0	0
c. Medium- and long-term debt (repayable within a year)	1,868	2,062	2,262
<b>5. Net current external debt (4-2a-2b-2c)</b>	<b>-6,020</b>	<b>-6,353</b>	<b>-6,898</b>

<sup>a</sup> End of period balances at current prices. Figures may not add due to rounding.  
<sup>b</sup> The figures of liabilities in this table are consistent with those published by the Central Bureau of Statistics. The data published by the Controller of Foreign Exchange are slightly different because definitions were revised at the beginning of 1993.  
<sup>c</sup> Excluding the balance of US government aid received in February 1996.  
<sup>d</sup> Of the nonfinancial private sector and the public sector.  
 SOURCE: Based on Central Bureau of Statistics data.

latter reflected the further reduction of the reserve requirement on the public's foreign-currency restitutions deposits, and the lower interest which the Bank of Israel paid on the banks' foreign-currency deposits.

In the first half of the year the banks imported some \$2 billion of capital, whereas in the second half they exported about \$1 billion (Figure 6.8). This apparently resulted from the introduction of swaps in August 1995, which supplied the banks with foreign currency from domestic sources, allowing a further expansion of foreign-currency domestic credit. Banks withdrew foreign-currency deposits from the Bank of Israel in 1994, too, amounting to \$1.8 billion, but in the absence of domestic use a substantial share of these withdrawals was invested abroad, resulting in net capital exports of \$1.2 billion.

As stated, all of the banking system's capital imports occurred in the first half of the year. This net capital inflow comprises mainly repatriation of overseas deposits at the

beginning of the period, and capital outflow due to a slight increase in credit to nonresidents. This latter increase reflects *inter alia* credit granted to foreign investors to purchase control of Israeli firms. Capital inflow in 1995 also reflects a rise in liabilities, mainly in nonresidents' deposits. A reversal of capital flows was observed in the second half of 1995, the result mainly of a rise in banks' deposits overseas in the last quarter of the year.

Since 1993 the spread between the relatively low interest rate of the currency basket (Figure 6.9)—which is based on the Libor rates weighted by the shares of the currencies in the basket—and the relatively higher interest charged by domestic banks on foreign-currency credit, which is calculated using the same weights, has been shrinking.

Libor is the basic interest rate in the world financial markets; it does not incorporate a country risk premium, and is determined competitively. In contrast, interest charged by local banks on foreign-currency domestic credit reflects the degree of competition in the domestic credit market, and the cost of the foreign-currency sources which the banks utilize to finance the credit they advance, a cost which depends on the country risk. The narrowing of the spread between these two interest rates attests to Israel's reduced country risk—which encourages capital inflow—and to increased competition in financial intermediation in Israel, whose effect is enhanced by the lower reserve requirement on the public's foreign-currency deposits. The increased competition in foreign-currency financial intermediation can be traced *inter alia* to the accessibility to international capital markets of Israeli borrowers—mainly large companies—in the context of the liberalization of capital movements.

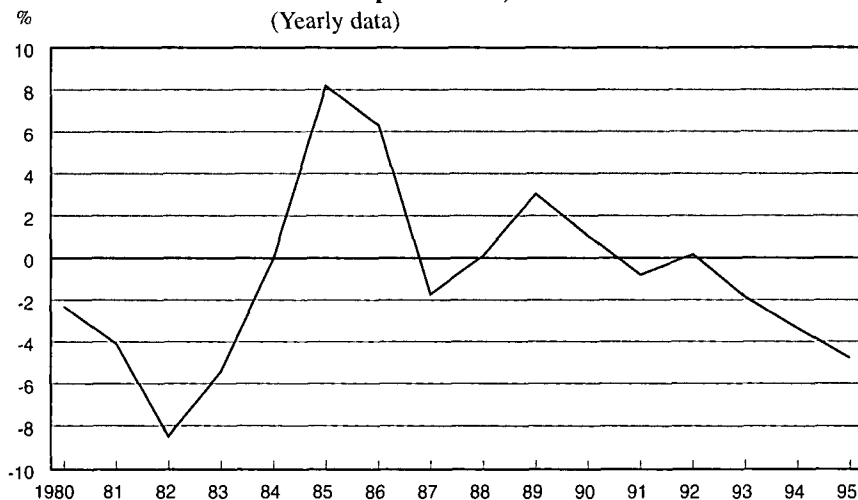
#### *The external debt and the reserves*

Israel's net external debt at the end of 1995—after taking into consideration the share of US government economic aid for that year which will be received in 1996—stood at \$18.3 billion, rising by some \$600 million during the year, having increased by \$1 billion in 1994.<sup>15</sup> Most of the external debt is long and medium term, and 12 percent of it is due to be repaid in 1996.

The \$4.1 billion deficit on the current account indicates that the calculation of the debt based solely on reported debts may be an underestimate. Assuming that the deficit on the current account is measured correctly, and after adjusting for net investments in Israel during the year (including portfolio investments), it can be said that the external debt in 1995 increased by about \$2.8 billion. It is thus reasonable to state that the actual increase in the debt was somewhere between \$2.8 billion and \$600 million, so that the claim that the debt/GDP ratio fell from 23.2 percent in 1994 to 22.1 percent in 1995—including the \$950 million of US aid for 1995 received in 1996—should be treated with some skepticism. Furthermore, this fall in the ratio also reflects the fact that domestic product prices rose faster than did the exchange rate of the dollar—by about 4 percentage

<sup>15</sup> The figures of the external debt were adjusted retroactively by the CBS in 1995. These adjustments raised the debt figure by about \$1 billion. All indices for 1995 which relate to the external debt are calculated on the basis of the assumption that US economic aid was received in its entirety.

**Figure 6.10**  
**Ratio of Current-Account Surplus to GNP, 1980-95**  
 (Yearly data)



SOURCE: Based on CBS data

points during the year—and it is not certain whether this relative price rise will continue. To overcome the problem of measuring the external debt accurately, another index—which estimates the economy's ability to bear the burden of expansion of the external debt—is often used, i.e., the current-account deficit/GNP ratio. Figure 6.10 shows that in 1995 this ratio passed its 1984 level, and approached that of 1983. In contrast with the two indices described above, the external debt/exports ratio, whose numerator and denominator are expressed in dollar terms, is therefore not affected by the differential rate of change in the exchange rate and in the domestic product price deflator. According to the official data, this ratio declined from 70 percent in 1994 to 62 percent in 1995, apparently indicating an improved ability to repay the external debt. Nonetheless, as stated, this improvement should be treated with caution, as some capital imports may not have been recorded accurately, leading to an underestimation of external debt.

The public-sector external debt fell by \$1.4 billion in 1995, so that the recorded rise of \$600 million in the external debt may be attributed entirely to the banking system and to the nonfinancial private sector, and reflects mainly the expansion of foreign-currency credit. As the net foreign liabilities of the public sector and the banking system are accurately recorded, it may reasonably be assumed that the gap between the reported and the actual increase in the debt derives from the nonfinancial private sector.

Gross foreign-currency assets of the public sector totaled \$8.7 billion at the end of 1995, compared with \$7.3 billion a year earlier. The increase in the reserves was small relative to the unprecedented \$6.2 billion foreign-currency conversions by the public.

This was due to the withdrawal of foreign-currency deposits from the Bank of Israel both by the banks—because of the reduction of the reserve requirement on restitutions deposits and of the interest the Bank paid on them—and by the government. This money financed the expansion of foreign-currency credit to domestic borrowers. Swap transactions introduced by the Bank of Israel to sterilize foreign-currency conversions also contributed to the reduction of the reserves. Despite the deterioration in the balance of payments and continued expansion of the external debt, the reserves rose, in terms of import months, from 2.3 to 2.8.