Chapter 6
The Balance of Payments

The current-account deficit soared to $ 2.8 billion in 1994, mainly because of the steep rise in the private-sector import surplus, reflecting the rapid expansion of all domestic uses of resources—private consumption, public consumption, and investment. The deficit reflects mainly the reduction in the private-sector saving rate. Alongside the rise in the import surplus, all components of both imports and exports continued to expand rapidly. However, the size of the current-account deficit raises questions as to Israel's ability to continue on this course. In 1994 the deficit was financed by capital imports by both the public sector—principally under the US government guarantees—and the nonfinancial private sector, in the context of monetary restraint, which gradually became tighter towards the end of the year. There were foreign-currency conversions by the public, but the reserves rose only slightly, because of capital exports by the banks. Although the external debt increased, the debt/GDP ratio declined mainly because of real appreciation during the year.

1. MAIN DEVELOPMENTS

The main feature of the balance of payments in 1994 was the steep rise in the current-account deficit due to the import surplus. The civilian import surplus reached $ 8.2 billion, representing a nominal increase of $ 2.2 billion; in terms of volume the increase was less, however, because of a 2 percentage point deterioration in the terms of trade (excluding diamonds, Table 6.1), incurring an estimated cost of $ 600 million in 1994. Over and beyond this cost, the deterioration in the terms of trade serves to reduce both demand, by restricting real income—although this was not evident in 1994—and supply, by impairing the profitability of production, particularly for export.

The current-account deficit—that part of the import surplus which is not financed by unilateral transfers—amounted to $ 2.8 billion in 1994.[1] A surplus of $0.4 billion had accrued in 1990–92, when the influx of immigrants was at its height, and in 1993 there was a deficit of $ 1.4 billion. In the wake of the mass immigration, the private-sector deficit rose to an annual average of $ 1.5 billion in 1990–93, after a surplus in 1985–89, following the economic stabilization program (ESP). In 1990–92 the private-sector deficit was financed through exceptional unilateral transfers to the public sector on account of

[1] When adjusted for advance payments for defense imports, the current-account deficit was $2.7 billion, up from a deficit of $ 1.1 billion in 1993 and a cumulative surplus of $ 0.1 billion in 1990–92. Since the trends are identical, the discussion here focuses on the unadjusted deficit.

Table 6.1
Selected Balance-of-Payments Indicators, 1983–94

	1983–86	1987–89	1990	1991	1992	1993	1994
$ billion, at current prices							
Total current account	–0.1	0.6	0.6	–0.4	0.2	–1.4	–2.8
Adjusted current account[a]	–0.4	0.6	0.4	–0.6	0.3	–1.1	–2.7
Import surplus							
Total	4.3	4.7	5.3	7.1	6.7	8.1	9.7
Civilian[b]	2.9	2.9	3.8	5.1	5.2	6.0	8.2
Civilian, excl. capital services	1.4	1.4	2.6	4.2	4.1	4.6	6.6
Net unilateral transfers							
To public sector	3.2	3.4	3.8	4.4	4.0	3.7	3.3
To private sector	0.9	1.7	2.1	2.3	2.9	3.0	3.6
Implied private capital imports[c]			0.4	–0.1	–2.4	1.1	1.7
External debt							
Net	17.9	17.4	15.1	15.2	15.2	15.7	16.5
Gross	29.5	31.3	32.8	33.3	34.1	36.0	40.0
Foreign reserves	3.9	5.2	6.5	6.4	5.3	6.7	7.1
Annual change, percent (volume)							
Exports[d]	5.3	2.9	5.0	1.6	14.4	12.7	8.0
Civilian imports[d]	2.7	6.3	10.2	15.3	11.9	11.4	12.9
World trade[e]	5.0	6.7	5.2	3.5	4.7	4.0	7.2
Exchange rate							
Against the dollar	0.75	1.65	2.02	2.28	2.46	2.83	3.01
Against the 5-currency basket	0.71	1.71	2.21	2.48	2.73	3.06	3.30
Net external debt as percent of[f]							
GDP	69.3	44.1	27.7	24.9	25.2	24.7	21.7
Exports	166.0	122.2	82.5	81.8	73.3	70.9	68.3
Relative prices (1988 = 100)							
Imports/GDP[g]	118	105	93	84	80	79	75
Exports/GDP[g]	118	104	93	89	86	84	79
Terms of trade[d]	95	98	98	102	104	102	100

[a] Adjusted for advances on defense imports.
[b] Excluding direct defense imports.
[c] Defined as the difference between the private sector's purchase of foreign exchange and its current account.
[d] Excluding diamonds and capital services.
[e] Based on IMF, *World Economic Outlook*, October 1994.
[f] Net external debt at end of year.
[g] Price index of imports (exports) *divided by* price index of GDP (from the national accounts); excludes direct defense imports and diamonds.

SOURCE: Based on Central Bureau of Statistics data.

the Gulf War and the influx of immigrants. These transfers declined in 1993, as expected, but the private-sector deficit did not shrink, even rising slightly, so that the total deficit grew (Table 6.2). The increase in the current-account deficit in 1994 was almost entirely due to the steep rise in the private sector deficit. Although transfers to this sector increased in 1994, they did not match the net rise in its imports of goods and services. However, the public sector was also responsible for increasing the private-sector import surplus because of its expansionary policy.

Table 6.2
Net Balance of Payments, 1990–94[a]

($ million)[b]

	1990	1991	1992	1993	1994
Goods and services account	–5,348	–7,091	–6,667	–8,120	–9,714
Private sector	–3,013	–4,460	–4,360	–4,829	–6,724
Public sector[c]	–2,335	–2,631	–2,307	–3,291	–2,990
Unilateral transfers	5,906	6,674	6,885	6,747	6,957
Private sector	2,119	2,319	2,853	3,034	3,616
Public sector	3,787	4,355	4,032	3,713	3,341
Current account	558	–417	218	–1,373	–2,757
Private sector	–894	–2,141	–1,507	–1,795	–3,108
Public sector	1,452	1,724	1,725	422	351
Medium- and long-term capital movements	150	129	–471	1,834	2,452
Private sector[d]	218	–526	–1,177	–84	477
Public sector	–68	654	706	1,918	1,976
Basic account	708	–288	–253	461	–305
Private sector	–676	–2,667	–2,684	–1,879	–2,631
Public sector	1,384	2,378	2,431	2,340	2,327
Short-term capital movements	–238	152	–345	–420	–64
Nonfinancial private sector	–22	337	–408	–678	–79
Public sector	–215	–185	64	258	15
Capital movements of banking system	–227	–370	–1,305	587	–1,241
Errors and omissions	272	332	445	853	1,680
Change in foreign reserves[e]	-515	173	1,457	–1,481	–70

[a] Figures may not add due to rounding.
[b] At current prices.
[c] 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.
[d] Net investment from abroad by individuals (line 7, Table 6.8) *plus* net receipts of the nonfinancial private sector (Line 3b, Table 6.9); some of the investments classified as long term may not necessarily fall into that category.
[e] Increase (-)/decrease (+); adjusted for dollar exchange rate of currencies in basket.

SOURCE: Based on Central Bureau of Statistics data.

In view of the surge in capital stock, indicating the expansion of capacity, as well as the relatively low level of the external debt and the debt/GDP ratio, on the face of it the current-account deficit did not represent a problem in 1994. The factors behind the sharp increase in demand, and its exceptional composition, can be regarded as essentially temporary, as is the deficit thus generated. Nonetheless, declining profitability could have an adverse effect on future growth, particularly of tradables, thus perpetuating the deficit.

Alongside the rise in the import surplus, there was great volume growth of both imports (excluding capital services) and exports—13 and 10 percent respectively (Table 6.3). Exports rose while their price in dollar terms declined, world trade picked up, and world trade prices rallied. The contribution of new markets to the increase in merchandise imports and exports declined in 1994, reflecting both the recovery of traditional markets and a slowdown in the establishment of ties with new ones. While merchandise trade does not indicate any significant progress toward greater openness of the economy, the rise in imported tourist services in 1993 and 1994 does.

In 1994 the current-account deficit was financed by capital imports by both the public sector—primarily under the US government guarantees—and the nonfinancial private sector, while the banking sector exported capital. The current-account deficit of the private sector was financed by foreign-currency credit from external and internal sources, and by sales of foreign securities.

The foreign-exchange reserves rose slightly as a result of conversions by the public which, together with the public sector's contribution, offset the effect of banks' withdrawals of foreign-currency deposits from the Bank of Israel—the main source of their capital exports during the year. These withdrawals were due, among other things, to the continued reduction of the reserve requirement on the public's foreign-currency deposits, and were reflected to a great extent by capital outflow, because of administrative restrictions that prevent the banks from freely converting foreign currencies. This capital outflow eased in the last quarter of 1994, due to growing demand by the public for foreign-currency credit in the wake of tighter monetary policy.

Capital imports by the private sector exerted upward pressure on the exchange rate. The Bank of Israel's intervention on the market mitigated this pressure—through purchases of foreign currency—and as a result there was only moderate local-currency depreciation during the year. Hence, the exchange rate remained below the midpoint rate, in contrast to previous years, when the deficit was financed *inter alia* by foreign-currency sales, giving rise to substantial local-currency depreciation.

The current-account balance of payments deficit was reflected by a rise in the external debt alongside a decline in the debt/GDP ratio, much of which is explained by the lower rise in the exchange rate than in the GDP deflator during the year. There is a danger that if part of the real appreciation in 1994 is temporary, and there is no improvement in the current-account balance of payments, the debt/GDP ratio will rise in the future. This development, together with the decline in reserves relative to Israel's economic needs, raises doubts as to the country's ability to persist in this course.

Table 6.3
Goods and Services Account, 1991–94[a]

	$ million				Annual change, percent: Price			Annual change, percent: Quantity		
	1991	1992	1993	1994	1992	1993	1994	1992	1993	1994
Imports										
Goods excl. fuel and diamonds	12,054	13,345	14,569	17,248	-1.1	-3.6	2.0	11.9	13.2	16.1
Fuel	1,474	1,713	1,742	1,658	-4.8	-11.3	-2.4	22.1	14.6	-2.5
Diamonds	2,551	2,911	3,341	3,873	5.6	0.7	4.2	8.1	14.0	11.2
Services[b,c]	4,767	5,002	6,061	7,146	-1.2	3.3	2.6	6.2	17.3	14.9
From administered areas	901	1,171	749	623	3.9	5.7	21.2	25.2	-39.5	-31.3
Subtotal	**21,747**	**24,143**	**26,462**	**30,550**	**-0.4**	**-1.9**	**2.5**	**11.5**	**11.7**	**12.7**
Capital services	2,558	2,525	2,396	2,657						
Direct defense imports	1,973	1,466	2,125	1,485						
Total imports	**26,277**	**28,134**	**30,983**	**34,693**						
Exports										
Goods, excl. diamonds[b]	8,357	9,158	10,434	11,681	0.4	-3.6	-0.7	9.2	18.2	12.7
Diamonds[d]	2,690	3,049	3,356	4,014	-0.3	9.9	-3.3	13.7	0.1	23.7
Services[b,c]	5,241	6,419	6,788	7,328	-0.5	-3.4	1.5	23.0	9.4	6.3
To administered areas	1,238	1,429	1,243	962	2.5	-5.8	-0.2	12.6	-7.7	-22.5
Subtotal	**17,526**	**20,055**	**21,820**	**23,985**	**0.2**	**-1.8**	**-0.5**	**14.2**	**10.8**	10.4
Capital services	1,661	1,410	1,042	995						
Total exports	**19,187**	**21,465**	**22,863**	**24,980**						
Trade deficit[b]										
Excl. diamonds and fuel imports	3,697	4,188	4,135	5,568						
Current surplus, diamonds	138	139	14	141						
Total trade deficit	5,033	5,762	5,862	7,085						
Surplus on services account[b,c]	474	1,416	726	182						
Civilian import surplus[c]	4,221	4,088	4,641	6,565						
Capital services imports, net	896	1,115	1,354	1,662						
Civilian import surplus	5,118	5,203	5,995	8,228						
Total import surplus	**7,090**	**6,669**	**8,120**	**9,713**						

[a] Imports c.i.f., exports f.o.b.
[b] Excluding administered areas.
[c] Excluding capital services.
[d] See Table 6.4 for breakdown of diamond exports.
SOURCE: Based on Central Bureau of Statistics data.

2. THE CURRENT ACCOUNT

The current-account deficit rose in 1994, reaching $ 2.8 billion. Almost the entire deficit was due to the private sector, whose import surplus amounted to $ 6.7 billion, and the ensuing deficit to $ 3.1 billion (Table 6.2). The current-account surplus of the public sector shrank slightly, due to the continued decline of unilateral transfers alongside a smaller reduction in expenditure. This reduction was accompanied by a change in expenditure composition, so that capital services imports rose and direct defense imports declined.

The increase in the current-account deficit in 1994 reflects the rapid rise of both investment and private consumption, the latter exceeding the increase in income. Fixed investment rose by some 13 percent in 1994, as a result of which gross capital stock for 1995 in the principal industries grew by 7.5 percent. While the rapid growth of capital stock indicates the expansion of capacity—and hence improved ability to repay the debt in the future—its economic viability should be examined. The cost of the US government guarantees in 1994 provides an estimate of the marginal cost of net borrowing to finance the current-account deficit for that year. In 1993 real domestic interest was similar to the real cost of the guarantees, i.e., 3–3.5 percent. In 1994 the marginal interest on the guarantees went up by about 1.5 percentage points,[2] compared with an increase of some 0.3 percentage points in real long-term domestic interest. It would seem, therefore, that it became less worthwhile to increase investment by borrowing abroad (see Chapter 2).

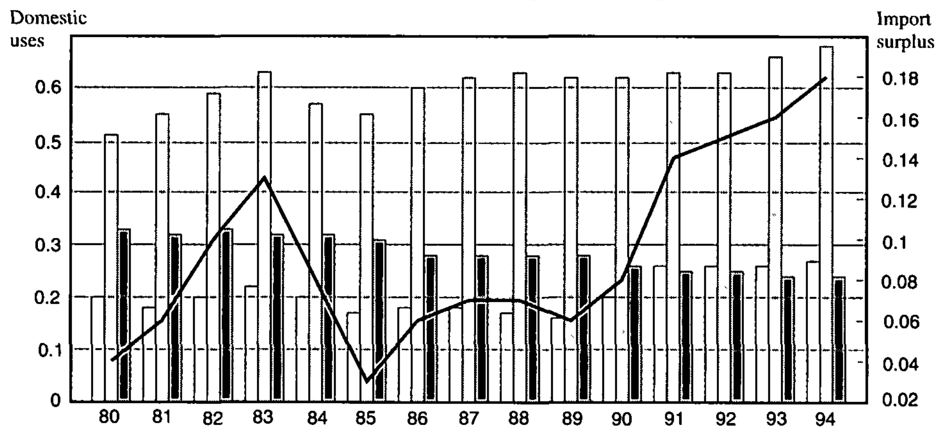
Much of the increase in the deficit was due to the expansion of private consumption alongside a 2.7 percentage point reduction in the private saving rate, bringing it down to 15 percent of national income. This decline was greater than the rise in the public saving rate, so that the national saving rate declined by 2.3 percentage points. Although the import surplus helps consumption adjust to its desired level, it increases the external debt without expanding capacity, thus constituting a burden on future consumption. A temporary change in private or public consumption, or in output, that leads to a reduction in the saving rate justifies a temporary increase in the deficit in order to 'smooth' consumption. The rapid expansion of capital stock, which indicates future capacity, as well as the levels of the external debt and the debt/GDP ratio, suggest that in 1994, uniquely, the current-account deficit is not a problem. If it were to increase on a permanent basis, however, accompanied by a steep rise in the debt—of the same magnitude as occurred in 1994—because of a permanent decline in the saving rate, the future cost would be great, increasing the interest rate, impairing growth, and harming future consumption.

Hence, the causes of the deterioration in the current account should be identified and the deterioration diagnosed as long-term or temporary. The analysis below indicates that the increase in demand in 1994 as well as its composition is on the whole temporary, but at the same time there was a decline in profitability that could impair growth in general, and that of tradables in particular, thus jeopardizing stability.

[2] Due to increased international demand for investment and higher long-term interest rates.

There are two main indicators of the extent to which domestic demand grew: the import surplus and real appreciation. The civilian import surplus (excluding capital services and diamonds) increased rapidly, its share in GDP in 1994 (in volume terms) rising by 2.2 percentage points, together with real appreciation of some 5 percent (a faster rise in the price of GDP than in that of imports, Table 6.1, Figure 6.1). While the increase in the import surplus reflects the rapid expansion of demand, the rise in its share in GDP denotes the extent to which it outstripped the ability of the latter to meet it.[3] Most of the steep rise in demand in 1994 was in goods affected by asset considerations—consumer durables and housing, as well as machinery and equipment—and there was also a sharp increase in imported tourist services. Since the tradable goods in these categories have a large import component, this led to a rapid rise in the import surplus. This is also reflected by the rate of real appreciation in terms of business-sector product—only about 1.5 percent. The gap between real appreciation in terms of GDP and in terms of average business-sector product in 1994 derives from the rise in the price of public consumption and of housing. The rise in the price of public consumption is due primarily to exogenous wage-increases in this sector, which do not yet reflect equilibrium in the factors of production, so that this price cannot serve as an indicator of the pressure exerted by demand on resources in 1994. Housing constitutes the nontradable component of assets, demand for which soared, as stated. This means that

Figure 6.1
Domestic Resource Use and the Import Surplus, as Proportion of GDP, 1980-94 [a]



[a] Excluding diamonds and capital services, 1990 prices.

[3] If there is an import surplus, equivalent rates of expansion of demand and GDP cause the import surplus to rise, but the ratio between the surplus and GDP remains unchanged. Consequently, a rise in the import surplus does not itself reflect the intensity of demand growth.

in 1994 real appreciation and the rapid rise of the import surplus indicate a unique composition of demand, and in order to assess the permanency of the import surplus it is necessary to analyze its underlying causes.

The rapid rise in domestic demand in 1994 encompassed all its components—public consumption, private consumption, and investment. The main causes of this were the steep rise in domestic expenditure by the public sector, led by wage payments, a decline in real interest—particularly at the end of 1993 and the beginning of 1994—and optimism about the peace process and its economic implications.

The public sector appears to have had an expansionary effect on economic activity in 1994, even though its domestic deficit contracted and the public consumption/GDP ratio declined (see Chapters 2 and 5). This was due mainly to exceptional public-sector wage increases in 1994, as well as the commitment to further substantial increases in 1995, which were thus perceived as permanent. This wage policy had an appreciable impact on private consumption in 1994, as did optimistic expectations regarding political developments in the region. These changes apparently contributed to an increase in individuals' expected permanent income, resulting in the faster expansion of consumption than of current income, i.e., a decline in the private saving rate. In the context of the level of interest, especially in the second half of 1993 and at the beginning of 1994 (see Chapter 7), consumption was brought into line with permanent income. Private consumption rose unevenly, as the accelerated increase in GDP and disposable income (both apparently unexpected), and the perception of the decline in real interest as temporary, boosted purchases of consumer durables. These purchases are in effect a form of saving by households, representing the transfer of consumption from the present to the future, and may have been affected this year by the easing of liquidity. There is a disadvantage to this kind of saving, since the decision as to the nature of future consumption is made in the present, but the instability and uncertainty of the financial markets in 1994 may have made the transition easier, causing a relatively large shift of savings from financial to physical assets, i.e., to consumer durables and housing (see section on housing in Chapter 2 and section on the composition of assets in Chapter 7). The increase in expected permanent income and the liberalization of trade also led to a rise in imported tourist services. Increased openness caused greater substitution between domestic and foreign tourism, as a result of the increase in variety rather than of their relative prices. The rise in tourist services accounted for 30 percent of the increase in the civilian import surplus (excluding capital services and diamonds) in 1994.

At the same time, in response to the increase in consumption, investment in the principal industries accelerated, particularly in machinery and equipment, which are import-intensive. Some 30 percent of the increase in investment was made by a handful of large companies, whose machinery and equipment requirements cannot be met from within Israel.[4] Since most consumer durables as well as machinery and equipment are not manufactured in Israel, the rapid rise in demand for them caused imports—and the

[4] They were consequently granted favorable credit terms by the foreign suppliers (see below).

import surplus—to surge.[5] In addition, a rise in the relative price of nontradables caused a further shift of demand to tradables. The decline in the relative profitability of tradables in 1994 hampered this sector's response, so that demand for tradables in general, and assets in particular, was met primarily by imports. Thus, the rapid expansion of domestic demand was biased towards imports.

All this indicates that the factors behind the rapid rise in demand in 1994 and its unique import-biased composition have mostly been exhausted. Real interest on local-currency credit rose steeply at the end of 1994. The wage increases expected in the public sector in 1995 were expressed, at least in part, in private consumption in 1994, and expectations arising from the peace process have moderated. It seems, therefore, that the demand factors that caused the surge in the import surplus and the ensuing deficit have eased to some extent.

Supply-side factors also play a part in determining the permanency of the deficit. The profitability of tradables production, particularly for export, appears to have deteriorated in 1994. Continued real appreciation in the last few years due to the structure of demand reveals the declining profitability of tradables vis-à-vis nontradables. Additional factors affected the profitability of tradables. Although real short-term interest was not high for most of 1994, domestic nominal interest was higher than that abroad. This gap led to capital imports by the private sector, to an extent that slowed the rate of local-currency depreciation and hence the exchange rate did not adjust to other nominal economic variables, particularly wage increases, so that real wages in the tradables sector rose faster than average business-sector wages. The temporary impairment of tradables' profitability hampered this sector's ability to expand, but by guaranteeing a lower inflation rate, it improves profitability in the long run. There was also a 2 percentage point deterioration in 1994 in Israel's terms of trade[6] (excluding diamonds, see Table 6.1), following a similar deterioration in 1993 and a 6 percentage point improvement between 1990 and 1992. The deterioration was partly due to a rise in international prices of raw materials resulting from economic recovery, and partly to the weakening of the dollar, since Israel imports more from Europe than it exports to it. The deterioration in the terms of trade, together with the rise in the price of imported intermediates, affects supply, as it reduces manufacturers' profits, and hence the quantity of finished goods produced at a given price. The profitability of tradables, and especially of exports, is impaired in this way since prices of tradables, in contrast to those of nontradables, cannot be raised. Alongside the deterioration in the terms of trade and wage increases, overall profitability has improved in recent years, so that the effect of its decline in 1994

[5] The existence of gaps between the composition of demand and domestic supply is common in small open economies, which do not necessarily produce every kind of merchandise. These gaps may change in the long run as a result of shifts in relative prices or technological change, but in the short run they are inelastic.

[6] Although a deterioration in the terms of trade reduces the income of countries that are net importers of goods whose price has gone up, the expansion of demand in 1994 indicates that this effect had not played a role. If the deterioration in the terms of trade persists, its results may be expressed in future demand (see Chapter 2).

is not yet reflected by supply, and exports (excluding capital services and diamonds) continued to expand rapidly (8 percent, Table 6.1). A decline in profitability reduces investment, however, causing capital expansion to slow, and possibly harming future growth.

Exports

There was a 13 percent volume rise in exports (excluding diamonds and goods to the administered areas) in 1994 (Table 6.4), down from 18.2 percent in 1993, but up from the 1990–92 and 1980–89 averages (5.2 and 8.2 percent respectively). At the same time, world trade grew by 7 percent, up from 4 percent in 1993, with a rise of 4.5 percent in world trade prices of industrial goods,[7] in contrast to a one percent decline in Israel's export prices in dollar terms. The correlation between the rates of change of the prices of Israel's exports and of the foreign trade prices of industrial goods shows that in the last few years the link between them has become weaker, while that between Israeli and US export prices has strengthened. The average price of US exports declined by 0.3 percent in 1994.

The deterioration in the terms of trade reflected a decline in the price of exports in dollar terms alongside a rise in the price of imports (both finished goods and intermediates). As stated, this was due in part to the rise in the world price of raw materials because of the economic recovery, and in part to the weakening of the dollar. The latter contributed about half a percent to the deterioration in industry's terms of trade. In 1994 a gap developed between the prices of goods sold domestically (wholesale prices) and those of exports (dollar export prices plus the change in the exchange rate). There are year-on-year fluctuations in the gap between the two prices, and there is no clear-cut connection between it and the volume change in exports.

This feature might be explained by observing long-term trends. Short-term fluctuations in prices do not appear to determine producers' sales patterns, due to the possibility of benefiting from economies of scale in export markets, so that the expected profit from new segments of those markets exceeds that from domestic sales. Consequently, bearing in mind the cost of penetrating and leaving export markets, if export prices fall one year relative to the price in the domestic market, producers will not necessarily respond by diverting production from the former to the latter. Thus, despite the decline in their relative price, merchandise exports—of both industry and agriculture—increased in 1994, as did their contribution to the increase in total exports.

The principal characteristic of exports in 1994 was its broad spread. The contribution of the three largest industries—electricity and electronics, transport equipment, and chemicals—to the rise in exports of manufactured goods fell from 87 percent in 1993 to 49 percent in 1994, due to the rapid rise in the exports of other industries.

[7] All data on other countries are based on IMF, *World Economic Outlook*, October, 1994.

Table 6.4
Merchandise Exports (f.o.b.), by Industry, 1991–94

	$ million				Annual change, percent					
					Price			Quantity		
	1991	1992	1993	1994	1992	1993	1994	1992	1993	1994
Agricultural exports	643	552	547	581	–12.7	–4.4	–3.2	–1.7	3.8	9.7
Citrus	*150*	*115*	*121*	*126*	–11.5	18.0	6.1	–13.0	–11.3	–1.4
Other	*493*	*436*	*427*	*455*	–13.0	–9.0	–5.4	1.8	7.3	12.7
Industrial exports	7,985	8,979	10,308	11,403	1.4	–3.4	–0.7	11.1	18.8	12.2
Metals, machinery, electronics	*3,504*	*4,064*	*5,042*	*5,721*	1.9	–1.5	0.7	13.8	26.0	12.7
Chemicals, rubber, plastics	*1,834*	*1,996*	*2,372*	*2,663*	–1.7	–5.8	–4.1	10.7	26.1	17.1
Other	*2,654*	*2,943*	*2,894*	*3,019*	2.9	–4.8	–1.3	8.5	2.7	5.7
Polished diamonds (net)	2,469	2,645	3,014	3,553	0.0	10.5	–3.7	7.1	3.1	22.4
Unpolished diamonds (net)	221	405	342	460	–1.9	4.6	–0.7	87.1	–19.2	35.5
less Returned exports	67	84	55	69						
Subtotal: FTS definition[a]	**11,219**	**12,479**	**14,083**	**15,929**	0.3	–0.9	–1.4	10.9	13.9	14.7
Balance-of-payments adjustments	–172	–272	–293	–235						
To administered areas	982	1,106	1,015	815	2.2	–6.2	–1.1	10.2	–2.1	–18.8
Total exports	**12,029**	**13,313**	**14,805**	**16,510**	0.4	–1.3	–1.4	10.2	12.6	13.0
Total excl. diamonds and exports to administered areas	8,357	9,158	10,434	11,681	0.4	–3.6	–0.7	9.2	18.2	12.7

[a] Foreign-trade statistics.

SOURCE: Based on Central Bureau of Statistics data.

Table 6.5
Merchandise Imports (c.i.f.), by Economic Destination, 1991–94

	$ million				Annual change, percent					
					Price			Quantity		
	1991	1992	1993	1994	1992	1993	1994	1992	1993	1994
Consumer goods	1,876	2,320	2,532	3,047	2.6	–1.0	0.6	20.5	10.2	19.6
of which Durables	957	1,250	1,283	1,498	3.7	2.6	1.9	25.9	0.1	14.6
Capital goods	2,996	3,180	3,577	4,510	2.5	–1.6	1.9	3.5	14.3	23.7
of which										
Machinery and equipment	2,107	2,240	2,522	2,962	2.4	–3.8	0.2	3.8	17.1	17.2
Land transport equipment	659	810	917	1,215	2.8	4.1	5.9	19.7	8.7	25.1
Total intermediates	11,868	13,130	14,190	15,964	–1.8	–4.7	2.4	12.7	13.4	9.8
Fuel	1,474	1,713	1,742	1,658	–4.8	–11.3	–2.4	22.1	14.6	–2.5
Diamonds (net)	2,551	2,911	3,341	3,873	5.6	0.7	4.2	8.1	14.0	11.2
Other	7,842	8,505	9,107	10,433	–3.2	–5.3	2.5	12.1	13.0	11.7
Merchandise n.e.s.[a]	–50	–66	–55	–77						
Subtotal: FTS definition[b]	**16,691**	**18,564**	**20,245**	**23,444**	–0.5	–3.6	2.0	11.7	13.2	13.5
Balance-of-payments adjustments	–611	–595	–593	–664						
From administered areas	190	249	178	130	7.5	–6.2	–3.8	21.9	–23.8	–24.2
Total imports	**16,270**	**18,218**	**19,830**	**22,909**	–0.4	–3.7	2.0	12.4	13.0	13.3
Total excl. fuel, diamonds, and imports from administered areas	12,054	13,345	14,569	17,248	–1.1	–3.6	2.0	11.9	13.2	16.1

[a] Net of returned imports.
[b] Foreign-trade statistics.
SOURCE: Based on Central Bureau of Statistics data.

The contribution of the non-traditional markets to the rise in exports declined in 1994. This was the result of both the recovery of exports to the traditional markets (the EU, USA, and EFTA) and the withdrawal from some new markets due to the instability associated with penetrating them. There was considerable variation in exports to new markets: exports to Asian countries other than Japan continued to rise rapidly, extending to most of the region, while exports to East Europe fell.

Imports

Imports (excluding fuel, diamonds and goods from the administered areas) grew by some 16 percent in 1994 (Table 6.5), their prices (in dollar terms) rising by 2 percent, after three successive years in which their prices fell. The rise in the price of Israel's imports in 1994 was smaller than that of the rest of the world. Prices of intermediates excluding fuel and diamonds rose by 2.5 percent, compared with 14 percent worldwide, and the prices of imported consumer and capital goods rose by 0.6 and 1.9 percent respectively, compared with a 4.5 percent increase in world prices of manu-factured goods. The explanation of the gap between the prices of Israel's imports and world prices appears to lie in their composition; for example, metals, whose world price soared, account for a much smaller fraction of Israel's imports than of total world trade.

While there is some substitutability between domestically produced and imported tradables, so that differences between their prices can cause demand to be diverted to the cheaper of the two, the steep rise in merchandise imports in 1994 was not due to substitution. Despite the slower rate of change in the nominal exchange rate than in domestic prices, there was no difference in prices when taken as an annual average: wholesale prices rose by 7.9 percent in local-currency terms, while in terms of the effective exchange rate (i.e., taking changes in import taxes into account), import prices increased by an average of 7.7 percent.

Due to the steep rise in demand for consumption and capital goods the contribut-ion of these items to the increase in total imports rose. Aircraft imports increased by $200 million in 1994, accounting for 20 percent of the rise in imports of investment goods. Intermediates (excluding diamonds and fuel) rose by 12 percent in 1994, though their contribution to the growth of total imports declined because of the rapid increase of other items. The slower expansion of imports of intermediates despite the more rapid growth of GDP in comparison with 1993 is due to lower investment in inventory in 1994 than in 1993, and the fuller response to demand by domestic production in general, and production of intermediates in particular. Most of the contribution to the rise in imports of intermediates in 1993 came from components and spare parts, rather than raw materials, and resulted from sharp changes in the composition of demand and from supply inelasticities. These problems seem to have abated in 1994, and the relatively full response of supply was also reflected by the slower growth of imported components and spare parts, their contribution to the increase in imported intermediates (excluding fuel and diamonds) declining from 60 percent in 1993 to 32 percent in 1994.

The volume of fuel imports declined by 2.5 percent in 1994, apparently marking the end of the process of increasing stocks which was due to the steep fall in fuel prices in recent years.

The liberalization of trade that began in September 1991 should have had an effect on Israel's imports, though to date it has been felt more in the composition of goods imported than in their regions of origin. This is because imports of goods subject to liberalization and coming from traditional markets rose faster than other imports.

The object of liberalization was to redress the imbalances arising from the system of quotas regarding countries with which Israel does not have trade agreements (third countries). The results of the trade liberalization program are not evident in the distribution of Israel's trade. In 1994 the contribution of nontraditional markets (including Japan and EFTA) to the rise in imports fell, reaching its lowest level since 1990—a year before the liberalization program was introduced and prior to the change in the international geopolitical situation. Although among nontraditional markets, imports from Asia (excluding Japan) continued to soar, some 40 percent of imports from these countries are electrical and electronic items, which are not included in the liberalization program, and which lead the expansion of imports from there. Thus, this increase seems to reflect the steep rise in purchases of consumer durables in 1994 rather than the effect of liberalization.

Table 6.6
Import Taxation, Selected Years, 1980–94[a]

(percent)

	1980	1986	1989	1990	1991	1992	1993	1994
Average tax rate								
Total imports	9	1	11	11	11	12	11	9
Consumer nondurables	20	25	23	22	22	24	20	18
Consumer durables	110	96	74	69	67	67	63	60
Intermediates	5	7	4	4	4	4	3	2
Producer durables								
Machinery and equipment	11	11	10	8	7	8	7	4
Motor vehicles	39	83	64	65	54	59	55	53
Change in average tax rate on total imports, due to								
Tax rates		1.7	–4.0	–0.8	–1.5	–0.2	–0.8	–2.4
Composition of imports		5.3	–1.0	0.8	1.5	1.2	–0.2	0.4
Average effective exchange rate of all imports		1.72	2.13	2.24	2.55	2.77	3.14	3.31
Coefficient of variation of effective exchange rates		0.24	0.20	0.21	0.22	0.23	0.22	0.22

[a] 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.

This does not mean that trade liberalization has failed. The openness that has resulted from it may also be reflected by a rise in imports from traditional markets and the increased efficiency of producers as a result of the threat from imports. Imports subject to liberalization increased from September 1991 to September 1994 by a cumulative 144 percent, compared with a cumulative rise in total imports of 35 percent in this period (nominal terms).[8] In the third year of the liberalization program (September 1993 to September 1994), imports of the goods affected rose by 32 percent, compared with an increase of 12 percent in total imports. Most of the import of these goods is from traditional markets, and therefore the share of third countries in it did not rise. The extensive import of these goods affords Israeli consumers a wider range of alternatives. This rep-resents a move in the right general direction and increases competition, but the pace of progress appears to be slow. Although in some industries, such as clothing and foot-wear, the share of imports in private consumption rose slightly, there was no change in the share of imports in total private consumption. The slow pace of liberalization may be enabling producers to restructure and respond to demand because of the threat of potential imports rather than the imports themselves. The slow pace of liberalization is also reflected by the failure to divert trade to the cheapest sources, so that no saving of foreign currency is evident. The lack of rapid progress is due to the slow pace of tariff reduction under the trade liberalization program as well as to the multiplicity of adminis-trative restrictions, e.g., standards and permits issued by government ministries. Since the latter are not bound by the liberalization program, they are not supervized in any way. The slow pace of tariff reduction under the program is deliberate, and is designed to give domestic manufacturers time to adapt production to new market conditions. The use of administrative restrictions, on the other hand, is neither part of the program nor desirable.

The average import tax rate fell to 9 percent in 1994, from 11 percent in 1993, after declining in 1993 (Table 6.6). Hence the rate of increase of the average effective exchange rate for imports was lower than the nominal exchange rate. The tax rate declined because of the reduction of tariffs, which account for 12 percent of tax revenues and whose share in them is declining.

Services account

The export surplus on the services account (excluding capital and the administered areas) fell to a trough of $ 180 million, principally because of the rapid growth of imported tourist services and the decline in exports of computer services. Expenditure by Israeli tourists abroad in 1994 rose by 25 percent in dollar terms and 14 percent in real terms and this increase may reflect the effect of expected permanent income. The price of imported tourist services rose by 11 percent, even though new and less expensive destinations opened up.

[8] State Revenue Administration, *Annual Report 1994*, No. 44, pp. 205–227 (Hebrew).

Tourist arrivals increased by a substantial 11 percent in 1994, but the number of tourist bed-nights rose by some 6 percent, and income from the export of tourist services by a real 5 percent. This means that the length of stay and expenditure per tourist declined. This may be due to the change in tourism by country of origin, with a significant decline in those from North America and a rise in those from the rest of the world, primarily Europe. Since expenditure per US tourist is double that of others, the decline in the proportion of tourists from the US depressed average income from each tourist. The contraction of tourism from the US appears to be connected with the weakening of the dollar, which reduced the attractiveness for Americans of travel abroad in general; beyond that, the continued political instability in the Middle East may have slowed the rise in the demand for tourism to Israel, in contrast to expectations at the beginning of the peace process.

The considerable extent of imported tourist services led to a sharp increase in imported transport services. Imports of other services (excluding the administered areas) rose by 18 percent in nominal terms, in the wake of the rise in the salary component to factors of production abroad. This was the result of the increase in the number of foreign workers in Israel, extensive imports of massive investment goods for which an initial period of installation and training is required, and a rise in Israel's direct investments abroad.

Unilateral transfers

In 1994 unilateral transfers rose by $200 million, with a decline in those to the public sector and an increase in those to the private sector. The reduction in the former was due primarily to the shrinking of direct defense aid. Hence it is also reflected in a commensurate fall in expenditure (direct defense imports) and does not increase the public-sector deficit. In addition, transfers to national institutions continued to decline. The share of unilateral transfers in total income is declining as a result of the contraction of dollar transfers, Israel's rapid GDP growth, the protracted real appreciation of recent years and, especially in 1994, real appreciation against the dollar.

Unilateral transfers to the private sector rose by $ 600 million in 1994, almost entirely due to cash transfers to individuals and a slight increase in restitutions from Germany. The latter have remained steady in the last few years—even though the number eligible for them has declined—because of new arrangements with the German government following that country's unification, the updating of payments in accordance with the cost of living in Germany, the arrival in Israel of immigrants from the former USSR who receive restitution payments, and—in 1994—the weakening of the dollar. Cash transfers to individuals have increased steadily since 1985, their growth accelerating in recent years. Most of the increase is in transfers to exempt persons, most of them immigrants who appear to have decided to transfer their assets to Israel a few years after immigrating, once they have made a final decision about where to live. The change in cash transfers to individuals is positively and significantly correlated with the change in short-term capital imports, and consequently these transfers may constitute part of the private sector's capital flow, which is subject to the administrative restrictions.

3. THE CAPITAL ACCOUNT

Capital movements, the financing of the current-account deficit, and the change in the reserves

As stated, the current-account deficit rose from $ 1.4 billion in 1993 to $ 2.8 billion in 1994, after a cumulative surplus in 1990–92. The total deficit reflects a private-sector deficit of $ 3.1 billion, and a public-sector surplus of $ 350 million. The deficit on the basic account, comprising the current account and long- and medium-term capital movements, was relatively small—some $ 300 million. This reflected a large deficit ($ 2.6 billion) on the basic account of the private sector, and a surplus of similar magnitude ($ 2.3 billion) on that of the public sector, the latter due mainly to money borrowed under the US government guarantees. The banking system exported $ 1.2 billion, part of which reflected its withdrawal of foreign-currency deposits from the Bank of Israel. The overall change in the level of the reserves was very small, however, with the private sector converting foreign currency. In view of the rather small overall deficit in the basic account, the relative stability of the reserves reflects short-term capital imports by the nonfinancial private sector that offset the capital export of the banking system.

A considerable extent of the capital imports of the nonfinancial private sector is unreported, and is indicated by the errors and omissions item, which was particularly large in 1994. Implied capital imports of this sector amounted to $ 1.7 billion in 1994 (Table 6.7), reflecting two principal factors: direct financing of relatively large import transactions connected with investment in machinery and equipment, and tight monetary policy, which was accompanied by the repatriation of overseas financial assets by residents. Net foreign-currency borrowing by the nonfinancial private sector (some $ 3.5 billion) exceeded implied capital imports in 1994. This was because in addition to foreign credit, it also includes loans from local banks' own sources, and from government earmarked deposits originating in US government credit under the guarantee scheme. For the first time in several years, the financing of the current-account deficit did not include foreign-currency purchases from the Bank of Israel, net conversions by the private sector amounting to some $ 350 million.

The opposing trends of the capital flows of the banks and the nonfinancial private sector apparently indicate significantly different assessments of optimal portfolio composition. This difference is misleading, however, since for reasons of stability the banks are subject to restrictions regarding the conversion of foreign-currency-denominated assets. Thus, in the absence of domestic uses, the accumulation of foreign-exchange sources beyond the level permitted for conversion will lead to a capital outflow.

Table 6.7
Balance of Payments, by Sector, 1990–94[a]

($ million)

	1990	1991	1992	1993	1994
Public sector					
Current account	1,284	1,540	1,792	687	444
Capital movements	–68	654	706	1,918	1,976
Basic account	1,216	2,194	2,498	2,605	2,420
Short-term capital imports	–47	0	–4	–7	–78
Capital movements via banking system	149	196	–26	–122	–218
Errors and omissions	–328	–315	–15	–331	–647
Effect on foreign reserves	–990	–2,075	–2,453	–2,144	–1,477
Private sector					
Current account	–894	–2,141	–1,507	–1,795	–3,108
Medium- and long-term capital movements	218	–526	–1,177	–84	477
Basic account	–676	–2,667	–2,684	–1,879	–2,631
Short-term capital imports	–22	337	–408	–678	–79
Capital movements via banking system	–376	–566	–1,278	709	–1,024
Errors and omissions	600	647	460	1,184	2,326
Effect on foreign reserves	475	2,248	3,911	664	1,407
Implied private capital imports	419	–107	–2,404	1,131	1,701

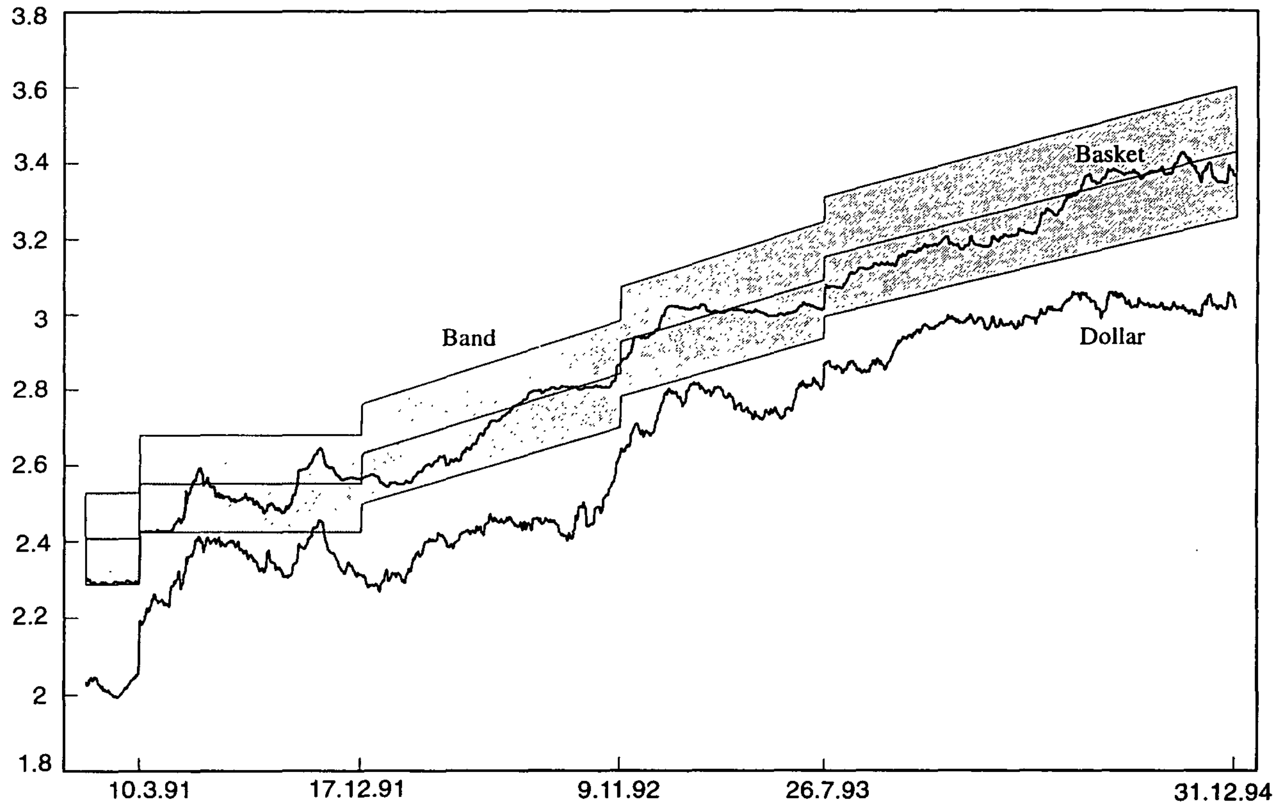
[a] Figures may not add due to rounding. The public-sector current account differs from the one in Table 6.2 due to an adjustment arising from advance defense payments.

SOURCE: Based on Central Bureau of Statistics data.

Capital imports during the year created pressure for local-currency appreciation, which was mitigated by foreign-exchange-sterilized purchases by the Bank of Israel. As a result, the depreciation of the NIS against the currency basket eased, and for most of the year the exchange rate remained below the midpoint rate (Figure 6.2). Pressure for local-currency appreciation was evident primarily in the first quarter, after interest had been raised, and in September–December when monetary policy became tighter. In each of these periods foreign-exchange conversions by the private sector amounted to some $ 270 million. Systematic foreign-exchange-sterilized purchases as a way of coping with capital imports triggered by tight monetary policy is problematic because the prevention of local-currency appreciation creates a narrower band within the exchange-rate target zone, thereby reducing maximum expected depreciation. Capital imports are thus enhanced, and the effectiveness of tight monetary policy is weakened. These factors may have been at work at the end of 1994 and the beginning of 1995.

The total current-account deficit was reflected by a rise in the external debt (in dollars), though the debt/GDP ratio fell (Table 6.1). This was because, first, the debt comprises only reported capital movements, although the large errors and omissions item indicates that there may also be unreported movements (Table 6.2), and second, the real apprec-

Figure 6.2
The Sheqel Exchange Rate Against the Currency Basket and the Dollar, 1991-94 [a]



[a] Weekly data (Mondays), in NIS per $ or NIS per currency-basket unit.

iation evident during the year eroded the share of the debt in GDP. If part of the real appreciation of 1994 was temporary, the debt/GDP ratio can be expected to rise.

The liberalization of foreign exchange

The liberalization process, which received an additional impetus in 1989, consisted *inter alia* of the gradual cancellation of restrictions on investment abroad—both direct and financial—by residents, the reduction of minimum periods for obtaining foreign-currency credit, and the removal of interest-rate ceilings on foreign-currency deposits and credit. These developments increased direct investment abroad by Israeli companies, and bolstered the expansion of their activities there. Furthermore, liberalization increased substitution between local- and foreign-currency credit, making demand for the former more flexible and thereby contributing to the reduction of the domestic interest-rate spread.

The liberalization of foreign exchange continued in 1994. All restrictions on direct investment abroad by Israeli companies were removed, and provident funds were permitted to invest 2 percent of their portfolio in foreign securities (the permit went into effect in February 1995). Towards the end of 1994 the restrictions on the use of credit cards for the purchase of foreign tourist services were canceled, and the foreign-currency allocation residents were allowed to take abroad with them was raised from $ 3,000 to $ 7,000 per trip. This relatively large amount, along with the permission to retain the residue in a foreign-currency deposit, reduced the effectiveness of restrictions on the purchase of foreign currency by the private sector arising from optimal portfolio composition considerations. Note, however, that the yield on financial investments abroad is relatively low, because of the tax on capital gains—calculated in foreign-currency terms—payable by individual and institutional investors. As a result, the liberalization of foreign currency is biased in favor of capital inflow, and in the short and medium term this may cause nominal appreciation, thus jeopardizing liberalization.

Under the liberalization program, the method of conducting daily foreign-exchange trading was changed in July 1994. The underlying principle was that trading would move from the Bank of Israel's dealing room floor to the commercial banks—first with respect to large transactions ($ 100,000 or more), and regarding all transactions after April 2, 1995. This transition was accompanied by a change in the rules governing trading, so that instead of multilateral transactions executed in the Bank of Israel's dealing room at the exchange rate that clears the market, continuous two-sided trading is conducted between customers and banks or between the banks themselves, at different exchange rates. The new rules still enable the Bank of Israel to intervene in the course of trading and directly affect the determination of the exchange rate, as central banks do elsewhere in the world.

The taxation of households' financial investments overseas : In contrast to households' financial investments in Israel, gains from their direct and indirect investments overseas (via provident and mutual funds) are taxed, The tax rate is 35 percent, in foreign-exchange terms, and the effective real tax rate is even higher.[9]

Taxation procedures on investment in foreign securities via mutual funds are simpler than those for private household investors. This favors these financial intermediaries and hence reduces competition. But even this way of investing is not without its disadvantages, because regulations limit the value of such investments to 50 percent of the value of the funds' portfolio. As a result, mutual funds might sell these assets just as they begin to show capital gains, because it is then that their weight in the portfolio exceeds the maximum permitted level. Foreign securities are sometimes sold to cope with extensive sales by the public of its participation in mutual funds, motivated by its desire to reduce its exposure in domestic financial assets. Under these circumstances, the funds tend to sell foreign assets to avoid exacerbating a fall in share prices on the domestic stock market, in which they constitute major players. Both these considerations appear to have motivated the repatriation of overseas financial investment in 1994.

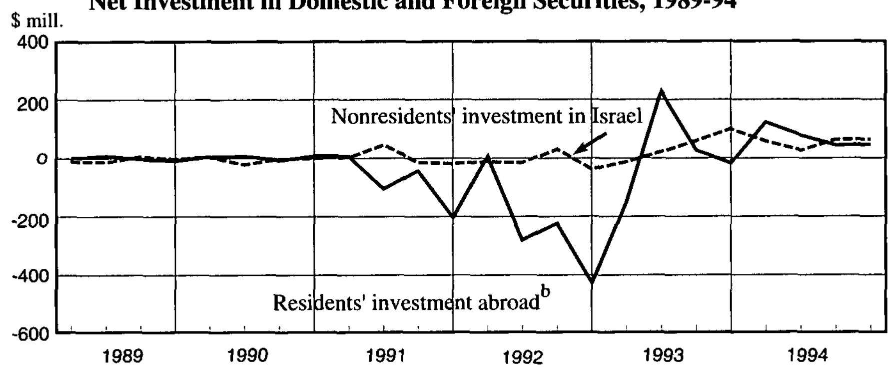
Restrictions on capital exports for financial investment have far-reaching effects in both the long and the short term. In the short term they prevent the efficient allocation of resources, reflecting the transfer of income from savers, who could obtain a higher return abroad, to borrowers. In the long run they prevent competition between foreign and domestic financial intermediaries, as it may be assumed that foreign intermediaries operate only in those areas where they have a comparative advantage over domestic ones, i.e., in financial investments overseas. Furthermore, as a result of these restrictions most financial investments by households are concentrated in the domestic capital market, exposing it to wide fluctuations and stock-market speculation. This is particularly relevant in view of the government's gradual exit from the capital market and the freeing of liquid assets resulting from the repayment of the domestic debt. Commitment to the exchange-rate regime, and the consequent importance attached to the level of the reserves, hampers any significant liberalization of capital exports. Even hesitant measures taken towards this end could cause extensive capital outflow, as domestic assets account for a very large share of the public's portfolio, due to the cumulative effect of capital outflow restrictions on its composition.

[9] This is because tax is paid on gross capital gains (before deduction of commission and other expenses arising from the sale of the asset), and because in the last few years there has been real appreciation in Israel, as a result of which domestic investors might pay tax on the basis of the existing arrangement even if, after adjusting for inflation in Israel, they incur losses. In addition, the interest paid on foreign-currency-denominated deposits and financial assets is taxed, while that on many local-currency deposits and government bonds is not. Furthermore, 5 percent of the value of the asset is deducted when an individual's assets abroad are repatriated. After tax returns have been submitted to the income tax authorities, the amount deducted should be offset by the tax on profits. Submitting a report involves objective costs (accountants' fees, time, energy, etc.) as well as subjective costs, which further reduce the return on financial investment abroad.

The nonfinancial private sector

Due to the liberalization of capital movements, many capital flows are not reported at all, or are reported with a delay. The disparity created between reported capital movements and the change in the reserves, on the one hand, and the current-account deficit, on the other, is accounted for by the errors and omissions item. On the basis of quarterly data since 1988, however, errors and omissions cannot be ascribed solely to unreported capital movements, and their interpretation as such should be treated with caution.

Figure 6.3
Net Investment in Domestic and Foreign Securities, 1989-94[a]



[a] Quarterly data. For residents' investment abroad, positive values signify sales, and negative ones investment.
[b] Not including investment in Israeli securities traded abroad.
SOURCE: Based on Central Bureau of Statistics data.

Long- and medium-term capital movements: As at the end of 1993, the reported capital movements of the nonfinancial private sector in 1994 were characterized by capital imports. The easing of long-term capital exports during 1993, and the capital inflow in the last quarter of that year, were connected *inter alia* with the boom on the Israeli stock market and the surge in offerings. Expectations (later proved wrong) that the boom would continue due to political developments in the region, made foreign-asset holdings less worthwhile. This assessment gave rise to a capital inflow that peaked towards the end of 1993, with sales of foreign securities, despite the reduction of domestic interest rates under the Bank of Israel's expansionary monetary policy (see last year's *Annual Report*). The main reasons for the capital imports of the nonfinancial private sector in 1994, however, were large import transactions, which were financed by suppliers' credit, and the continued sale of foreign securities by residents triggered by declining share prices on the Israeli stock market and tight monetary policy.

Table 6.8
Investment in Israel by Nonresidents, and Investment Abroad by Residents, 1990–94

($ million)[a]

	1990	1991	1992	1993	1994
1. Investment by nonresidents	296	587	1,231	5,682	1,532
Traded securities	45	103	387	4,847	897
Direct	248	508	824	815	617
Bonds[b]	2	1	3	2	0
Merchandise	–22	–44	–11	–8	–9
Reinvestment of profits	22	19	28	27	27
2. Repatriation of investment by nonresidents	216	221	727	4,960	915
of which Investment in traded securities	65	88	422	4,680	687
Direct investment	150	134	305	280	229
3. Net investment by nonresidents	81	366	504	721	616
of which Investment in traded securities	–20	15	–35	167	210
Direct investment	98	375	519	534	388
4. Investment abroad by residents	346	1,355	2,087	2,985	1,591
of which Investment in traded securities	165	926	1,424	2,035	744
Direct investment	181	428	663	949	847
5. Repatriation of investment abroad by residents	194	586	510	2,143	1,054
Investment in traded securities	178	581	497	2,122	1,033
Direct investment	16	5	13	21	21
6. Net investment abroad by residents	152	769	1,577	842	537
Investment in traded securities	–14	345	926	–86	–289
Direct investment	165	423	651	928	826
7. Net investment from abroad by individuals (3–6)	–71	–403	–1,073	–121	79
of which Investment in traded securities	–6	–330	–961	253	500
Direct investment	–67	–49	–132	–394	–438
8. Foreign securities held by banks[c]	358	–83	341	816	577
9. Total net investment from abroad (7–8)	–429	–320	–1,414	–937	–497

[a] Numbers may not add due to rounding.
[b] Redemption of independence and development bonds for investment.
[c] Includes investment in foreign securities by banks.
SOURCE: Based on Central Bureau of Statistics data

Table 6.9
Long- and Medium-Term Loans, 1990–94[a]

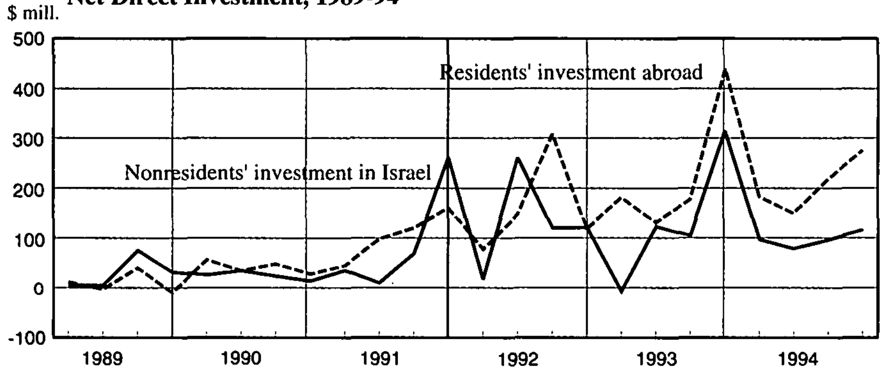
($ million)

	1990	1991	1992	1993	1994
1. Receipts					
a. Public sector	1,004	1,693	1,808	3,209	3,522
State of Israel Bonds	728	966	1,210	1,092	1,015
Bonds guaranteed by US government	0	400	0	2,015	2,402[b]
US government loans	0	0	0	0	0
Other foreign governments	62	237	359	82	87
Other government loans	213	89	239	19	18
b. Nonfinancial private sector	930	1,053	659	689	1,055
Total receipts	1,934	2,746	2,467	3,898	4,577
2. Repayments					
a. Public sector	1,072	1,038	1,102	1,291	1,546
State of Israel Bonds	438	401	436	550	692
Bonds guaranteed by US government	136	170	212	244	270
US government loans	229	233	236	235	248
Other foreign governments	137	112	140	140	145
Other government loans	132	122	79	122	191
b. Nonfinancial private sector	641	1,176	762	652	658
Total repayment	1,713	2,214	1,865	1,943	2,204
3. Net receipts					
a. Public sector	–68	654	706	1,918	1,976
State of Israel Bonds	290	565	774	542	323
Bonds guaranteed by US government	–136	230	–212	1,772	2,132
US government loans	–229	–233	–236	–235	–248
Other foreign governments	–75	125	219	–58	–58
Other government loans	82	–33	160	–103	–173
b. Nonfinancial private sector	289	–123	–104	37	397
Total net receipts	221	532	602	1,955	2,373

[a] Excluding loans of the banking system. Figures may not add due to rounding.
[b] Including $ 80 million, substitution of old debt for bonds guaranteed by US government.
SOURCE: Based on Central Bureau of Statistics data.

Reported capital imports (Tables 6.2, 6.8, and 6.9), which amounted to some $ 480 million, consisted mainly of net credit taken during the year ($ 400 million). Suppliers' credit from abroad appears to have financed some of the medium- and long-term capital inflow of the nonfinancial private sector in the first half of 1994 as a result of import transactions, particularly of machinery and equipment, by several large firms. The moderate extent of the remaining capital import (some $ 80 million) is due to the development—to a similar extent but in opposite directions—of the two main components of investment, securities and direct investment (both net). Thus, capital imports associated with stock-market investment amounted to $ 500 million, following repatriation of $ 290 million of foreign assets by residents (including $ 100 million by mutual funds, for portfolio considerations) and financial investment of $ 210 million by nonresidents on the Tel Aviv Stock Exchange (TASE) (Table 6.8). Net direct investment (including real estate), on the other hand, showed a capital outflow of some

Figure 6.4
Net Direct Investment, 1989-94[a]



[a] Quarterly data. For residents' investment abroad, positive values signify capital outflow and negative ones capital inflow.
SOURCE: Based on Central Bureau of Statistics data.

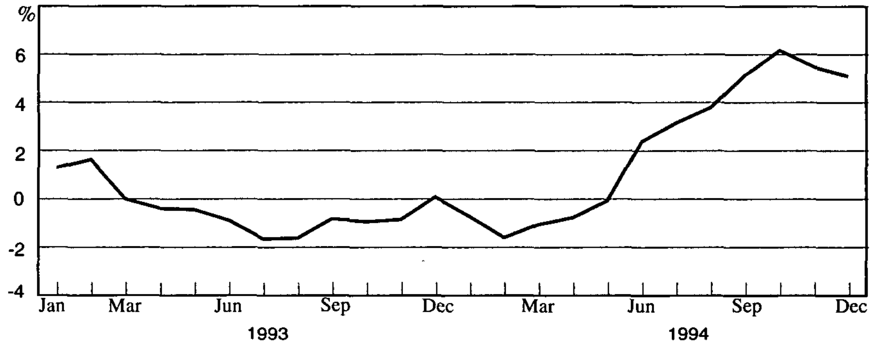
$ 440 million, comprising direct investment of $ 390 million in Israel by nonresidents and investment abroad of $ 830 million by residents.

Direct investment abroad by residents and in Israel by nonresidents has expanded steadily since 1991 as a result of the liberalization of foreign exchange, with the former rising faster, thus giving rise to a net capital outflow. The two kinds of investment (Figure 6.4) are highly correlated as a result of the increasing openness of the economy. Moreover, the sustained trend of direct investment overseas by residents that has been evident since 1991 attests to Israel's gradual integration within international markets, as the overseas production and marketing activities of Israeli firms increase. The fact that direct investment abroad does not reflect the differential between domestic and foreign interest rates indicates the importance of the long-term profitability considerations behind these investments, which are not necessarily associated with short- and medium-term developments in financial markets.

The trend of capital movements during the year raises some questions, because most of the reported capital inflow occurred in the first half of the year, while in the second half, when monetary policy was at its tightest, there was capital outflow. Most of the latter reflected repayments of long-term loans, which are predetermined and hence not sensitive to domestic interest-rate changes, alongside direct investment abroad by residents because of long-term profitability considerations.

Short-term capital movements: The $ 80 million capital outflow of the nonfinancial private sector (Table 6.2) evident in 1994 reflects a rise in exporters' credit, on the one hand, and net sales by residents of Israeli securities traded abroad, on the

Figure 6.5
The Spread Between the Yield on Treasury Bills and the LIBOR (3 month) Rate, 1993-94[a]



[a]Monthly data, annualized.
SOURCE: Bank of Israel, and IFS.

other. Exporters' credit grew from $300 million in 1993 to $440 million in 1994, mainly as a result of the exceptional ($365 million) rise during the last quarter, in the context of a significant increase in merchandise exports.

Net sales by residents of Israeli securities traded abroad amounted to $ 130 million and $ 140 million in the first and second halves of 1994 respectively. This process appears to have reflected the comprehensive share-price slide on the TASE and the fact that some 25 percent of Israeli shares traded abroad are also traded in Israel (another third of these shares belong to companies closely associated with others whose shares are traded on the TASE).

The lack of correspondence between reported short-term capital movements and monetary restraint during 1994 is even more surprising, because alongside the tightening of monetary policy in the second half of the year, the differential between domestic and foreign interest rates (adjusted for expectations of local-currency depreciation) increased (Figure 6.5).[10] This discrepancy is resolved for both short- and long-term capital movements if implied capital imports, which continued to assume large proportions in the second half of the year (some $ 1.5 billion), are taken into consideration.[11]

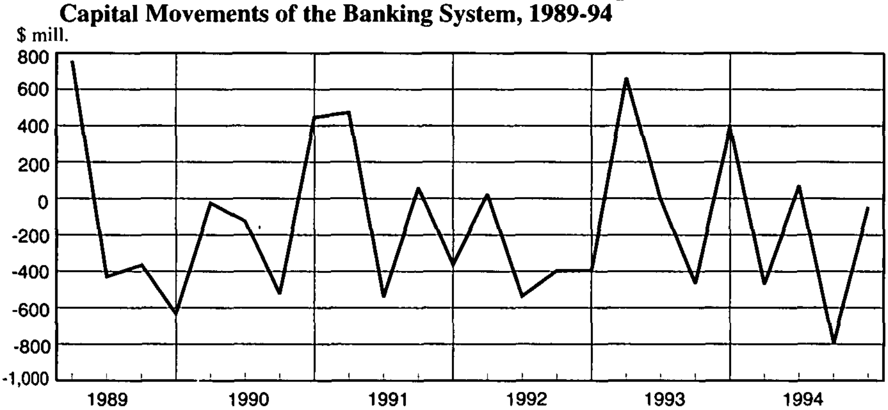
[10] Income tax of 35 percent (on the interest in currency-basket terms) is deducted from the local-currency yield on foreign assets. This is a weighted average of the Libor interest on the currencies comprising the currency basket. Interest abroad in local-currency terms includes an estimate of depreciation expectations. It is derived from the gradient of the slope of the exchange-rate band *plus* the distance of the exchange rate from the midpoint rate.

[11] As it is impossible to classify unreported capital imports as short- and long-term, all implied capital imports must be considered as a whole.

The banking system

As in 1991 and 1992, the capital movements of the banking system in 1994 were influenced by the continued reduction of the reserve requirement on foreign-currency (restitutions) deposits, a process which began in 1991, and by the restrictions which prevent banks from freely converting local-currency assets and liabilities into foreign currency (and vice versa).[12] Net capital exports by banks amounted to $ 1.2 billion in 1994, $ 580 million of it investment in foreign securities, following net capital imports of $ 590 million in 1993 because the interest rate paid by the Bank of Israel on banks' foreign-exchange deposits in the first quarter of 1993 exceeded the rate prevailing at the time on the international financial markets. The 1994 capital exports reflect a $ 2.2 billion increase in the banking system's foreign assets, alongside a $ 1 billion rise in its foreign liabilities. The source of the rise in its foreign assets is *inter alia* the transfer abroad of foreign-currency assets, a large part of which ($ 1.8 billion) were withdrawals from deposits with the Bank of Israel.

Figure 6.6
Capital Movements of the Banking System, 1989-94[a]



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

These withdrawals mainly reflect the continued reduction of the reserve requirement—by 1.5 percentage points a month, enabling the banks to withdraw some $ 800 million from the Bank of Israel in 1994. Additional domestic foreign-currency sources were released upon the annulment of the obligation to deposit foreign exchange with the Bank of Israel as collateral for the monetary loan. These deposits rose in 1993—particularly as

[12] During the period under review the banking system was permitted to increase its net local-currency assets (liabilities) by selling foreign-currency assets of up to $ 230 million. This limit was raised to $ 500 million in 1995.

the monetary loan increased towards the end of the year. The Bank of Israel recognized indexed Treasury bonds held by the banks as collateral, thus further reducing the need for foreign-exchange deposits.

The capital outflow persisted throughout 1994, moderating in the last quarter (when it was only $ 45 million) as a result of the increase in the public's demand for foreign-currency credit in the context of tighter monetary policy. Capital imports by the nonfinancial private sector are generally inconsistent with capital exports by banks, because in principle, residents may borrow from domestic rather than foreign banks. The fact that this did not occur in 1994 is apparently because part of the public could borrow abroad at better rates.

The public sector

Capital imports by the government rose in 1994, as a result of borrowing under the US government guarantees, which to some extent replaced other sources of long-term credit. Net borrowing by the government served mainly to extend credit to the private sector and offset deposits withdrawn from the Bank of Israel by the banks.

Net capital imports by this sector (short-, medium-, and long-term) amounted to $ 2 billion in 1994 (Table 6.2), compared with $ 470 million and $ 770 million in 1991 and 1992 (the years before the latest US guarantees) respectively. These inflows reflect mainly changes in the government's long-term borrowing, i.e., new loans of $ 3.5 billion and repayment of principal of $ 1.5 billion. Some $ 2.4 billion of total long-term borrowing in 1994 consisted of bonds issued under the US government guarantees, and another $ 1 billion through State of Israel Bonds. Repayment of principal consisted mainly of redemptions of State of Israel Bonds (about $ 700 million), and repayment of US government loans ($ 250 million) and of old bonds guaranteed by the US government ($ 270 million, Table 6.9).[13] These redemptions do not yet reflect repayment of principal for loans taken up under the new guarantees, for which there is a 10-year period of grace.

According to the loan agreement with the US government, Israel may borrow up to $ 2 billion per US fiscal year (for five years). In 1994 Israel borrowed $ 400 million in excess of this amount as the result of two developments. Some $ 350 million was deducted from the annual amount guaranteed by the US government to counterbalance infrastructure investment in the administered areas, and an additional loan of $ 750 million was brought forward to November—the 1995 US fiscal year—largely because of the expected increase in dollar interest rates on the capital markets. The average cost of the two tranches borrowed in March and September 1993 amounted to 7.5 and 6.9 percent a year respectively, compared with annual rates of 7.7, 8.6 and 8.8 percent

[13] These redemptions are connected with the debt substitution of 1988, when Israel issued bonds guaranteed by the US government against 90 percent of the debt.

percent a year respectively, compared with annual rates of 7.7, 8.6 and 8.8 percent respectively for the three tranches borrowed in 1994—reflecting a rise in interest rates on the US capital market.

Alongside the utilization of the US government guarantees, there was a slight decline in net and gross borrowing through State of Israel Bonds, as well as in borrowing from other sources (Table 6.9). State of Israel Bonds consist of non-negotiable notes and bonds, which in 1994 were issued in equal amounts. Bonds are usually sold to individual investors, while most notes are sold to foreign institutional investors, and hence do not strengthen ties with world Jewry. The proportion of Israel Bonds debt accounted for by fixed-interest bonds has declined from 75 percent in 1980 to 27 percent in 1994, while the proportion of variable-interest bonds and notes in 1994 was 33 and 40 percent respectively.[14] On the face of it, the cost of this form of borrowing is the same as that of borrowing through flotations of fixed-coupon bonds under the guarantees. In fact it is higher because of distribution costs of 0.66 percent of gross borrowing. Moreover, the notes are put options since they can be cashed at par (after five years) and bear a variable interest rate. These characteristics should have made the notes cheaper than fixed-coupon bonds.[15]

Public-sector borrowing from governments other than the US and from other sources increased in 1989–92, but has declined since then, amounting to an annual $ 85 million (gross) in 1994 and 1993, compared with $ 360 million and $ 240 million in 1992 and 1991 respectively.

The public sector's contribution to the reserves in 1994 was $ 1.5 billion (Table 6.7) which, together with private-sector foreign-currency conversions of $ 350 million, offset the banks' withdrawal of foreign-exchange deposits from the Bank of Israel.

4. THE EXTERNAL DEBT AND THE RESERVES

Israel's net external debt rose by some $ 800 million in 1994, after increasing by $ 450 million in 1993, having remained steady in 1990–92 at $ 15.2 billion (Table 6.10). This rise is mainly accounted for by the $ 1.4 billion net increase in the banking system's foreign assets and the $ 2 billion increase in the government's external debt, its share of the total external debt rising from 84 percent in 1993 to about 92 percent in 1994. The debt/GDP ratio fell from 24.7 percent in 1993 to 21.7 percent in 1994.

These developments do not give the whole picture, however. The decline in the foreign reserves resulting from credit extended to the private sector by the government via the banks and financed by money borrowed under the US guarantees is recorded as government debt, and formally the government is responsible for its repayment, but in effect it represents substitution between the rising external debt and the falling internal

[14] Serussi, S. *Israel Bonds, the State of Israel's Bonds*, February 1995 (Hebrew).

[15] The premium Israel paid for borrowing under the guarantees in November 1994 in order to issue 5-year bonds at fixed rather than variable interest was 1.5 percent.

debt. Furthermore, the calculation of the net external debt is based solely on reported capital movements. If unreported capital movements since 1983 are included, the debt rises by $ 2 billion, amounting to 24 percent of GDP at the end of 1994. Similarly, in the last few years Israel has experienced real appreciation over and beyond the long-term trend. Thus, had it not been for the exceptional increase in domestic prices relative to the NIS/dollar exchange rate in 1994, the debt/GDP ratio would have been 4 percentage points higher. This is relevant in view of the likelihood that at least part of the appreciation was temporary, implying that this ratio may rise in the future.

Table 6.10
Assets and Liabilities in Foreign Currency, 1990–94[a]

($ million)

	1990	1991	1992	1993	1994
1. Gross liabilities[b]	**32,817**	**33,259**	**34,127**	**35,972**	**39,960**
a. Government	16,702	17,316	18,138	19,912	22,248
b. Nonfinancial private sector	4,586	4,289	3,886	3,675	4,105
c. Banking system	11,529	11,654	12,102	12,385	13,607
2. Gross assets	**17,694**	**18,085**	**18,899**	**20,278**	**23,457**
a. Bank of Israel reserves	6,316	6,298	5,131	6,385	6,795
b. Other financial institutions	600	557	534	669	542
c .Exporters' credit	2,462	2,333	2,472	2,769	3,017
d. Banking system	8,317	8,897	10,761	10,455	13,103
3. Net external debt (1–2)	**15,122**	**15,175**	**15,229**	**15,693**	**16,502**
4. Total current external debt	**6,196**	**5,980**	**1,633**	**2,874**	**3,730**
a. Banking system	2,834	2,727	589	2,187	780
b. Nonfinancial private sector	1,548	1,389	1,117	886	888
c. Direct government debt	0	0	0	0	0
d. Medium and long-term debt (repayable within a year)	1,814	1,865	–72	–198	2,062
5. Net current external debt (4–2a–2b–2c)	**–3,182**	**–3,208**	**–6,504**	**–6,948**	**–6,624**

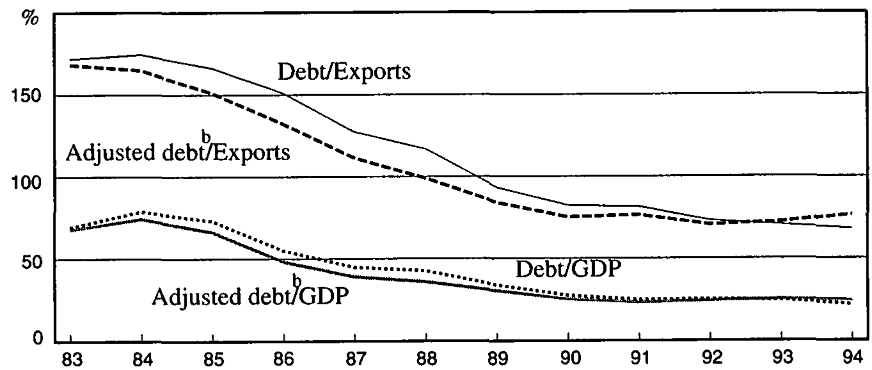
[a] End-period balances. Figures may not add due to rounding.
[b] The figures of liabilities in this table are consistent with those published by the Central Bureau of Statistics. The data published by the Controller of Foreign Exchange are slightly different because they were revised on different dates.
SOURCE: Based on Central Bureau of Statistics data.

Assuming that Israel's total external debt is $ 17.5 billion,[16] and that real GDP grows in accordance with potential GDP (6 percent a year), the annual current-account deficit that guarantees the stability of the debt/GDP ratio, in the absence of continued real appreciation, is $ 1.1 billion, far below the 1994 deficit of $ 2.8 billion. The development of the current account and the external debt reflect the trends of domestic use of resources and

[16] This amount is the average between the official external debt of $ 16.5 billion and the 'adjusted' external debt of $ 18.5 billion after the inclusion of unreported capital movements since 1983.

GDP. The declining profitability evident in 1994 could harm future growth, and if there is no commensurate slowing of domestic use of resources, the deficit will be perpetuated and the debt/GDP ratio will rise. If this turns out to be the case, the present path of the balance of payments may not be sustainable.

Figure 6.7
Ratio of External Debt to GDP[a] and Exports, 1983-94



[a] End-year prices.
[b] Debt adjusted for errors and omissions from 1983.

The level of the foreign-exchange reserves was relatively high at the end of 1994—some $ 7 billion—up from $ 6.7 billion at the end of 1993. Their average level also rose, from $ 5.7 billion to $ 6.3 billion, but their share in the civilian import surplus declined significantly—from 95 percent in 1993 to 77 percent in 1994. In terms of import months, the average level of the reserves remained stable (2.3 import months), even though it declined during the year, continuing the trend of 1992–93. This decline was more than offset by the massive capital inflow at the end of 1994 and the beginning of 1995. At least some of this inflow seems to have been of a short-term nature, however, resulting from the significant differential between domestic and foreign interest rates towards the end of the year.

The net current external debt declined in 1994 (Table 6.10). This, alongside the rise in the share of medium- and long-term debt in the total debt, reflects Israel's improved debt-repayment ability, as does the decline in the share of overnight bank deposits (SROs) in the Bank of Israel's reserves.

Nonetheless, the large current-account deficit, which could raise the debt/GDP ratio, raises doubts as to Israel's ability to continue on its current course.