

Part 1
The Balance of Payments

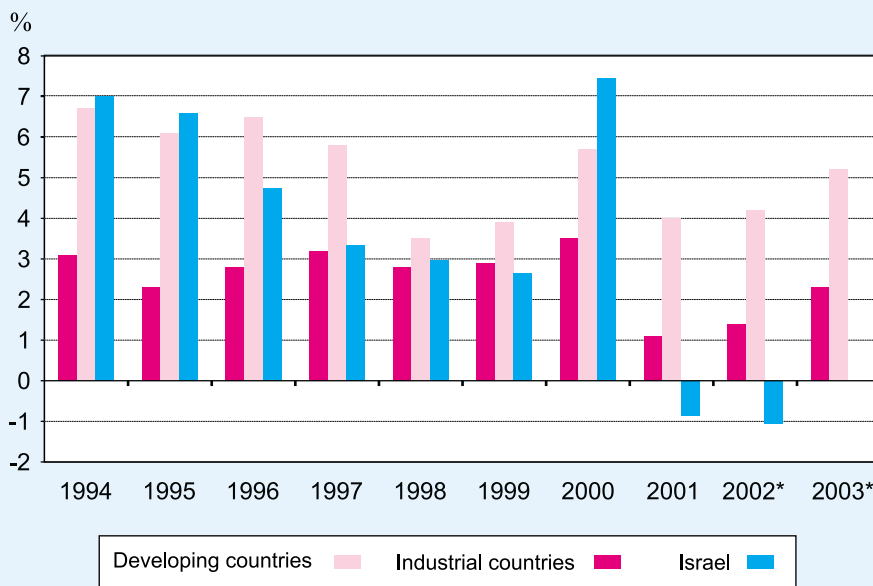
Chapter 1

Main Developments¹

Since the Israeli economy is small, open, and technological, it was strongly affected in 2002, as in 2001, by the continuing global economic slump, particularly in high-tech. Global and domestic economic and security developments that began to unfold in late 2000 were part of Israel's economic scene in 2002 and were reflected in a contraction of activity in the balance of payments.

The contraction of activity in the current and financial accounts, pursuant to the trend in 2001, was brought on by domestic and global factors that are sometimes difficult

Figure 1.1
Development of Real GDP; a Global View, 1994-2003



*The data for these years are estimates.

SOURCE: IMF Report, 2002.

¹ This chapter does not discuss the macroeconomic aspects of the current account. For an expanded discussion of this topic, see the section of this report on Output and the Principal Industries, the Labor Market, and the Budget and the General Government.

to isolate in terms of their effects on activity. The domestic factors include the conflict with the Palestinians, which escalated in 2002, and the recession. The global factors include an upturn in geopolitical risks, continued global economic sluggishness (Figure 1.1) and, in particular, the high-tech slump, which was manifested in an acute crisis in the capital and issues markets. Since global high-tech demand recovered in the second half of 2002, the exports of Israel's high-tech industries in Israel did so as well.

The deficit on balance-of-payments current account was 2.1 percent of GDP in 2002, approximating the level in previous years—2 percent of GDP—except for 2000 (Table 1.1). Among the factors that affect the current account, the continued global slump, especially in high-tech, and the ongoing security difficulties had an upward effect on the deficit. These factors were offset by the domestic recession, which depressed imports, and by the real currency depreciation.

The deficit on balance-of-payments current account has leveled off at 2.1 percent of GDP.

Table 1.1
Israel's Balance of Payments, 1998–2002

	1998	1999	2000	2001	2002
	(\$ million)				
1. Net goods, services, and factor inputs (a+b+c)	-7,527	-8,355	-7,545	-8,683	-8,684
a. Net goods	-3,267	-4,464	-3,089	-3,264	-3,757
Exports	22,974	25,577	30,947	27,678	27,424
Imports	-26,241	-30,041	-34,036	-30,942	-31,181
b. Net services	-191	739	2,654	-572	-1,027
Exports	9,445	11,447	15,183	11,991	10,396
Imports	-9,636	-10,708	-12,529	-12,562	-11,423
<i>of which: Tourism</i>	542	1,405	1,055	-485	-444
Revenues	3,015	3,971	3,859	2,460	2,103
Expenditures	-2,473	-2,566	-2,804	-2,945	-2,547
Other services	1,580	1,797	4,433	2,726	2,089
c. Factor revenues	-4,070	-4,629	-7,110	-4,848	-3,901
1. Net interest and dividends	-1,323	-1,692	-3,938	-1,961	-1,422
2. Net wages	-2,747	-2,938	-3,172	-2,887	-2,479
<i>of which</i> Wages of foreign workers	-995	-1,217	-1,387	-1,145	-890
Wages of Palestinian workers	-1,879	-1,875	-1,950	-1,908	-1,744
2. Net current transfers	6,080	6,316	6,469	6,399	6,550
3. Current account (1 + 2 = 3)	-1,448	-2,039	-1,076	-2,285	-2,134
4. Capital account and financial account	239	2,809	3,679	654	214
a. Capital account	577	569	455	681	150
b. Financial account (excl. net reserve assets)^a	1,542	3,259	3,788	-284	-746
1. Direct investments	612	1,940	1,664	2,089	585
2. Portfolio investments	2,505	1,768	2,947	-910	-1,910
3. Other investments	-1,574	-449	-823	-1,463	579
c. Net reserve assets^a	-1,880	-1,018	-564	256	810
5. Statistical discrepancies (-4-3 = 5)	1,208	-770	-2,604	1,631	1,920
Current-account deficit as percent of GDP (percent)	-1.4	-2.0	-0.9	-2.0	-2.1

^a Capital inflows and increases in liabilities are marked with a positive sign (+); decreases in liabilities and increases in assets are marked with a negative sign (-); increases in reserve assets are marked with a negative sign (-).

SOURCE: Based on Central Bureau of Statistics data.

In the financial account, the downtrend in activity accelerated. Nonresident investment declined by three-fourths relative to the level observed in 1999–2000, the ‘bubble’ years in global capital markets, and by one-fourth relative to 1998. Although net investment decreased and the deficit on goods, services, and factor-inputs account was unchanged, net debt issues actually declined because current and capital transfers sufficed to finance the deficit. However, net payback of external debt slowed in 2002 relative to previous years due to a large surplus of nondebt sources.

In the financial account, the downtrend in activity has strengthened.

The deficit on goods, services, and factor-inputs account was \$ 8.7 billion in 2002, resembling the 2001 level. The global slowdown, especially in high-tech, affected high-tech exports even though this downturn was partly offset by the decline in high-tech imports. The security situation continued to affect the deficit in 2002 as inbound tourism revenues continued to slump after a steep decrease in 2001. The inbound-tourism decline was offset by a decrease in outbound-tourism expenditure, occasioned by the domestic economic slump. Since the current phase of the conflict with the Palestinians began (October 2000), tourist arrivals have fallen by two-thirds relative to previous years. The escalation and perseverance of the confrontation also resulted in larger government expenditure on defense imports, although the extent of the increase was not significant.

Israeli exports, in which high-tech industries account for a large share (Table 1.2), were affected by continued sluggish growth in global high-tech activity, especially in communications, computers, and electronics. Thus, high-tech exports decreased by 11 percent and software exports declined even more severely. High-tech imports also decreased, due to the correlation between exports and imports—especially in communications and electronics—and offset some of the decrease in exports. In the goods account of non-high-tech industries, the diamond industry stood out by increasing its volume of activity considerably on both the import and the export sides, partly due to nonrecurrent changes in international trading rules.

Table 1.2
Estimate of Share of High-Tech^a in Goods and Services Account and in Financial Account, 1998–2002

	<i>(percent)</i>				
	1998	1999	2000	2001	2002
Goods account (excl. diamonds)					
Exports	44	46	53	50	48
Imports ^b	23	28	27	28	33
Services account (incl. factor inputs)					
Exports	38	20	33	17	13
Imports	48	10	8	8	10
Financial account					
Nonresidents' investments	24	49	84	94	55
Residents' investments (excl. Bank of Israel reserves)	38	8	50	8	4

^a High-tech industry: electronics, medicines, software, aircraft, & R&D.

^b Data for the share of the high-tech industry in goods imports are up to September 2002.

SOURCE: Based on data from CBS and on banks' and firms' reports.

Net current transfers of the private sector decreased for the first time while those of general government were stable.

Net capital inflow in the financial account stopped in 2001 and did not resume in 2002.

Foreign direct investment fell short of the levels observed prior to the boom years.

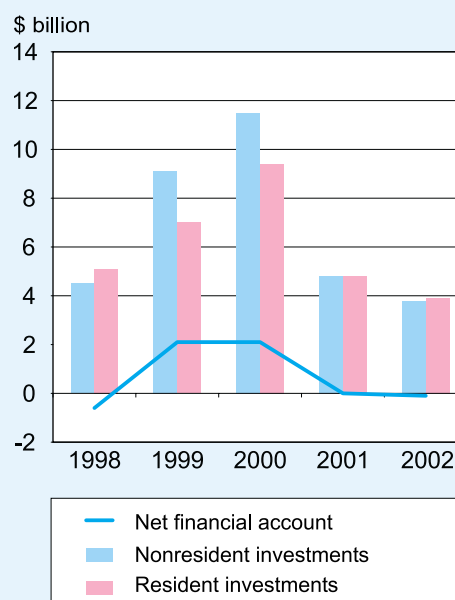
Current transfers financed the deficit on goods, services, and factor-inputs account (less statistical discrepancies) with no need for further sources. Net current transfers to general government, composed mainly of US Government defense and civilian aid, have been stable in recent years. In contrast, net current transfers of the private sector decreased in 2002 for the first time, for reasons including a decline in nonresidents' wealth. Notably, large statistical discrepancies in recent years make it difficult to analyze the components of the balance of payments, especially in respect to the financing of the goods, services, and factor-inputs account.

In the financial account, foreign investments and resident external investments declined by about one-fourth relative to 2001. Net capital inflows in the financial account, which were substantial during the years of the global economic boom—largely due to the technology orientation of Israel's economy—stopped in 2001 and did not resume in 2002 (Figure 1.2). The nonbanking private sector recorded net capital outflows in 2001 and 2002, with greater momentum in the latter year than in the former, due to domestic factors. However, general government and, in the main, the banking sector offset these flows with a net capital inflow.

When it became clear that the global markets and economy would not rebound quickly, foreign investment in emerging markets generally and in Israel particularly diminished (Figure 1.3). Private capital flows to emerging markets at large decreased by 5 percent and issues on American stock exchanges fell by 45 percent. In view of weakness in the markets and the decrease in capital flows, Israel's high-tech intensity led to a steep contraction of its share in capital flows and, especially, in issues abroad.

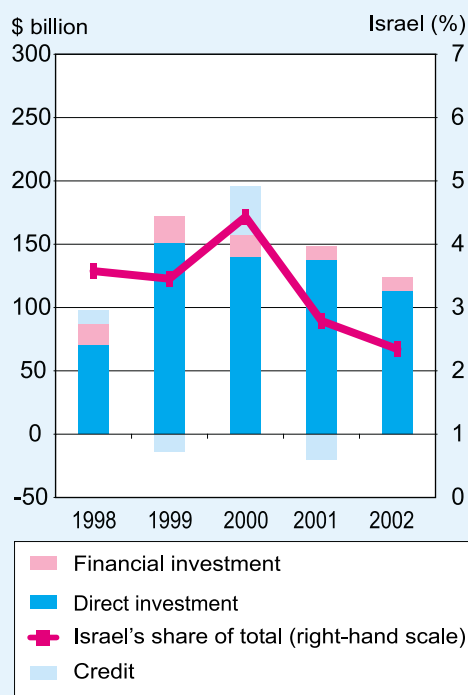
The perceptible impact of external events on nonresidents in 2002 was manifested in a decline in foreign direct investment (FDI), in a reversal of the trend in recent years. FDI, which had had a stabilizing effect on total foreign investments because it was less affected by passing events, decreased in 2002 for the first time and did so perceptibly, falling to levels that were low even relative to the years preceding the 'bubble' (1999–2000). This occurred due to investors' internalization of the awareness that the global crisis, especially in high-tech, would not pass quickly and due to nonresidents' perception of

Figure 1.2
Nonresident Investments and Resident External Investments, 1998-2002



SOURCE: Based on reports from banks, companies, and Ministry of Finance.

Figure 1.3
Private Capital Flows to Emerging Markets, and Israel's Share of Them, 1998-2002



SOURCE: Institute of International Finance, *Capital to Emerging Markets*, January 2003

investment in Israel as a riskier endeavor in 2002 than theretofore. Thus, individual nonresident deposits in Israel decreased this year—for the first time in many years—by \$ 0.8 billion.

Residents were influenced in 2002 by the same domestic and global factors that influenced nonresidents. However, residents were more strongly affected by domestic developments, including the undermining of trust in macroeconomic policy, completion of the forex liberalization, and, perhaps, the tax reform. The total flow of external resident investments slowed and the composition of resident investments changed: direct investments were stagnant, portfolio investments increased, and 'other investments,' mainly accrual of deposits abroad, decreased.

The effect of the erosion of public confidence in macroeconomic policy was strongest among households, which invest both directly and by means of mutual funds. Most of the impact occurred in the first half of the year and was manifested chiefly in acquisition of

Households expressed the erosion of confidence in macroeconomic policy by transferring money to external deposits and acquiring foreign bonds.

bonds and accrual of deposits abroad. In the second half of the year, the flow of such transactions slowed and, in part, turned around due to the interest rate increase and the restoration of confidence in the economic policy.

Israel's credit risk increased in 2002 in view of the lengthy contraction of economic activity. For example, for the second straight year the ratio of gross external debt to GDP rose and rating companies' outlooks on the country risk deteriorated. Nevertheless, Israel's sovereign rating was not downgraded in 2002, due to the decline in net external debt and the high ratio of short-term external assets to short-term external debt.

The contraction of activity was more severe in the financial account than in the current account. It traces to the decline in nonresidents' financial wealth, occasioned by the steep downturns in global financial markets, where high-tech companies are especially susceptible to developments. In contrast, global demand for goods, including those in high-tech, did not decline in 2002 and therefore made only a modest contribution to the downturn in current-account activity.