

this type is Israel Bonds, which substitute for the issue of negotiable bonds as a way of raising capital. Net capital raised by means of Israel Bonds was \$ 10 billion at the end of 2004. Gross issues declined in 2004 from the record level of \$ 1.5 billion in 2003 to the 2002 level of \$ 1.3 billion. The cost of Israel Bonds issued in 2004 was still 20 basis points higher than that of negotiable Israel Government bonds of a similar term. The decline in issues of Israel Bonds in 2004 was facilitated by other Government issues that were backed by U.S. guarantees. In the past, the Government regularly raised capital from foreign governments, international institutions, and foreign banks as well. Outstanding credit from these sources was \$ 2.8 billion at year's end, \$ 0.3 billion lower than the year-earlier level.

2. RESIDENT EXTERNAL INVESTMENT

a. Main developments

Resident external investment flows continued to climb in 2004 and totaled \$ 9.6 billion.

The balance of resident external investment increased by \$ 11.6 billion (13 percent) during the year and came to \$ 100 billion at year's end. Investment flows were \$ 9.6 billion as against \$ 7.4 billion a year earlier (Tables 1.3.2, 1.3.3), originating in global and domestic factors that affected different subsectors in different ways. Several investment-encouraging factors that had been evident in 2003 intensified this year. Global factors, foremost the continued global high-tech recovery, abetted increases in direct investment and external deposits of the business sector in view of the upturn in high-tech exports and the recovery of the American issues market. The globalization process, in which large companies are taking part, also had an upward effect on direct investments. In contrast, the weakness of the American capital markets and the sluggish global performance of the dollar slowed investments by households and institutional investors in foreign shares and bonds. Domestic factors include the narrowing of the interest spread, which induced repayment of forex credit, and an increase in resident forex deposits, resulting in a surplus of forex sources in the banking system that was deposited abroad.

Direct investment of the business sector increased against the background of the high-tech recovery and continuing integration into globalization processes.

Direct resident external investment was \$ 3 billion, up 25 percent from 2003, and the balance at year's end was \$ 16 billion. Most investment of this type is made by the business sector (Table 1.3.5). The direct-investment behavior of this sector, especially its high-tech component, is influenced mainly by global trends and reflects the sector's efforts to be part of them. This year, in view of the high-tech recovery, several large acquisitions of manufacturing firms were made and several companies that developed in similar directions began to prepare for large acquisitions that will mature in the near future. The global integration of the domestic business sector is reflected in a transition from equity-holders' loans, which were typical of investments in the early 1990s and were meant mostly for the establishment of marketing systems abroad, to capital investments in manufacturing systems.

Table 1.3.5
Investments of Israeli Residents Abroad

							(\$ billions)	
	1999	2000	2001	2002	2003	2004		
Total investment flows	5.9	9.3	4.3	4.2	7.4	9.6		
Direct investment	1.0	3.5	0.7	1.0	2.1	3.0		
Investment in tradable securities ^a	0.8	2.1	1.1	2.5	2.5	1.0		
<i>Of this:</i> Bonds	1.1	1.3	1.2	2.2	1.9	0.9		
Shares	-0.5	1.5	0.4	0.6	0.9	0.6		
Other investments ^b	2.7	2.9	2.0	1.3	1.6	5.2		
<i>Of this:</i> Deposits	1.7	1.5	3.4	2.1	1.5	5.3		
Public sector	1.5	1.0	0.4	-0.7	1.3	0.0		
<i>Of this:</i> Bank of Israel reserves	0.9	0.9	-0.2	-1.0	0.9	0.4		
							Change in 2004	
							<i>Of this:</i> price and exchange	
							Total ^c	rate differences
Balance of investments (end-of-period)	60.4	69.3	72.3	78.0	88.4	100.0	11.6	1.4
Direct investment	6.4	9.4	9.5	10.5	13.1	16.0	2.9	0.1
Investment in tradable securities	4.9	7.2	7.9	10.1	13.7	15.9	2.2	0.4
<i>Of this:</i> Bonds	3.4	4.7	5.9	8.3	10.6	11.7	1.1	0.2
Shares	1.4	2.5	2.0	1.8	3.1	4.2	1.1	0.2
Other investments	25.8	28.7	30.4	32.4	34.3	40.3	6.0	0.4
<i>Of this:</i> Deposits	13.8	15.4	17.3	19.5	20.8	26.4	5.6	0.3
Public sector	23.4	24.0	24.5	25.0	27.3	27.7	0.4	0.5
<i>Of this:</i> Bank of Israel reserves	22.5	23.2	23.2	23.7	25.8	26.6	0.8	0.5

^a Including transactions in forwards and futures.

^b Other investments include deposits in foreign banks and credit to foreign residents.

^c Total change in the balance of investments composed of investment flows, price and exchange rate differences as well as other adjustments that are not presented here.

SOURCE: Reports of the banks and companies, data of the Ministry of Finance and processed data of the Department for Economic Activity in Foreign Currency.

Portfolio investment, including foreign shares and bonds, decreased by 60 percent to \$ 1 billion and the balance at year's end was \$ 15.9 billion. External investments of households, provident funds, and advanced-training and pension funds increased at the beginning of the year, pursuant to a trend that began in 2003:IV in view of the protracted narrowing of the interest spread and the effect of the tax reform. From 2004:II, however, the trend turned around and realizations ensued due to the paltry returns that these investments were yielding. Insurance companies, which are unaffected by the reform, also slowed their external investing severely during this time. The business sector reduced its portfolio investments moderately, as transfers out of the country by subsidiaries of multinational corporations, which invest their surplus liquidity abroad for reasons of the parent companies' global policy considerations, offset realizations by other companies.

Other investments, composed of external deposits and credit to nonresidents, tripled to \$ 5.2 billion—nearly all in deposits—bringing the balance at year's end to \$ 40.3 billion. The banking sector deposited \$ 4 billion abroad as part of its

The banking system transferred \$ 4 billion out of the country because domestic activity generated surplus forex sources.

management of surplus sources from domestic activity, after having removed \$ 1.8 billion from the country for the same reason in 2003. The surpluses of forex sources originated mainly in an increase in the public's forex deposits and repayment of forex credit. In the business sector, exporting and issuing companies, which conduct most of their activity in forex, increased their external depositing in view of the recovery in these areas of activity, and companies in the financial sector did the same as backing for rather large issues of financial instruments in the domestic forex market. The household sector, unlike the business sector, cut back on its external depositing in 2004. Credit to nonresidents, mainly commercial credit, increased by 9 percent in view of the recovery of exports, but the upturn was offset by nonresident repayment of credit.

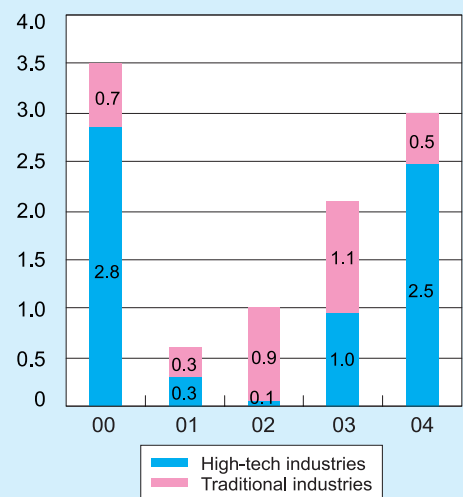
The ratio of external assets to total assets of the public has been level in recent years.

The proportion of external assets in the public's total portfolio has been stable at around 8 percent during the past five years, whereas its proportion in the forex portfolio declined in 2002 and recovered gently in the past two years to 37 percent. The latter development occurred despite several processes that should have diverted assets to destinations abroad: Israel's integration into international markets, the elimination of tax discrimination due to the reform, the deregulation of investments by institutional players, and the narrowing of the yield spread as an improvement in the credibility of macroeconomic policy caused Israel's country risk to decline. Thus, although the long-term process does favor the diversion of assets to destinations abroad, short-term factors—the weakness of foreign capital markets and the appreciation of the NIS against the dollar—mitigated the process. Additional factors that tended to slow the adjustment of the portfolio included the period of time needed to learn the markets and install the infrastructure for external investment, a strong home bias, households' lack of awareness of the new investment opportunities abroad, and banks' marketing efforts vis-à-vis households, which were considerably milder this year than before.

b. Direct investment

Total direct resident external investment rose by 19 percent and came to \$ 16 billion at year's end—\$ 14 billion by the nonbanking private sector and \$ 2 billion by the banking sector (Table 1.3.2). Direct investment flows were \$ 3 billion. All were generated by the business sector; \$ 2.5 billion of the total originated in high-tech industries (Figure 1.3b.1).

Figure 1.3b.1
Direct Investment Flows of the Private Sector Abroad, by Investor's Technological Intensity, 2000–04 (\$ billion)

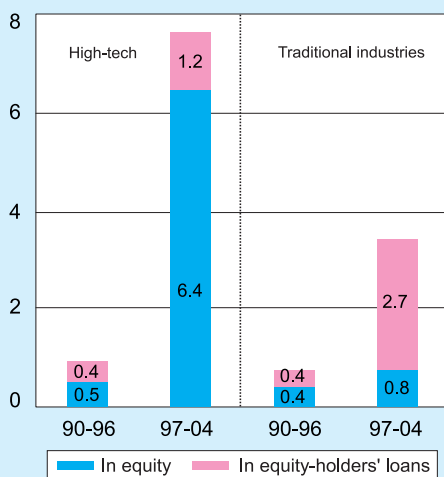


SOURCE: Based on bank and company reports.

The globalization process has affected direct investments of the business sector in recent years; domestic high-tech firms have made large acquisitions of manufacturing and marketing systems abroad and these industries' level of global activity has been volatile. In the past two years, amid the high-tech recovery, direct investments by Israeli high-tech firms increased, although the peak attained in 2000, the "bubble year," has not recurred. In 2000, however, most transactions were effected by means of share swaps, resulting in parallel increases in nonresident investment and resident external investment, and the initiative was taken by nonresidents. In the past two years, in contrast, the proportion of cash investment has increased and the initiative has been taken by the Israeli firms that perform the acquisitions. The investment trend among specific industries was not uniform: there were steep increases by the pharmaceuticals and software industries, as against net realizations in electronics and telecommunications which continued the trend evident during the past four years, although to a lesser extent. Among traditional industries, investments by chemical firms were flat and investments by the construction industry increased. Construction investment was affected mainly by the slump in the domestic market, which has prompted the industry to divert its investments to destinations abroad in recent years. Notably, the value of real-estate assets acquired abroad far exceeds the portion financed by residents, i.e., the investment flow. This year, for example, \$ 1.4 billion in real estate was acquired while the equity investment originating in Israel was only \$ 0.5 billion. Loans from foreign banks financed the remainder.

The effect of globalization was also reflected in the mix of direct investments, i.e., those performed by means of equity acquisition or by equity-holders' loans. In

Figure 1.3b.2
Direct Investment of the Business Sector in Equity and Equity-Holders' Loans, by Investor's Technological Intensity, 1990–2004 (\$ billion)



SOURCE: Based on company reports.

1990–1996, the proportion of equity investment in total direct investment was 50 percent in all industries. In 1997, however, due to the effects of globalization and large investments by high-tech companies, the share of equity in direct investment climbed to 84 percent among high-tech industries and declined to 23 percent in traditional industries, even though the latter, too, increased their investments overall (Figure 1.3b.2). The reason has to do with the purpose of the investment. Traditional industries make much of external investments in marketing companies, in which the proportion of loans is large. High-tech firms, in contrast, invest in the formation or the acquisition of manufacturing firms, which entail an investment in equity for

The globalization of high-tech industries is reflected in two transitions: from investment by means of loans to investment in equity and from acquisition of marketing firms to acquisition of manufacturing firms.

reasons including the need to obtain foreign financing for their activity. In addition, Israel's mix of equity versus loans is unusual by the standards of the West, where the share of equity in investments was 83 percent in 2001–2002. This is evidently because the Western countries began their integration into the globalization process, which manifests itself in the acquisition of manufacturing firms, before Israel's business sector did.

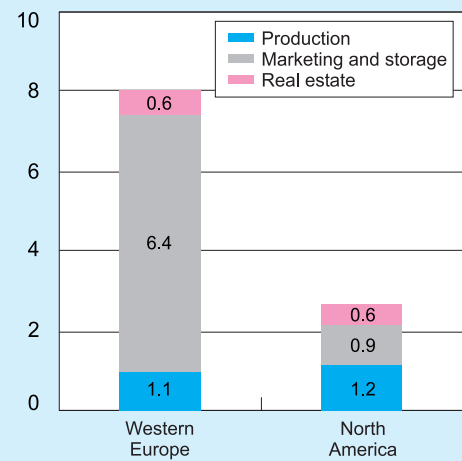
Investments have a stronger focus on marketing in Europe than in North America.

Analysis of the geographical distribution of direct investments shows that North America and Western Europe, Israel's main trading-partner regions, are also the main targets of direct investments of the business sector. Investments in North America correspond to global fluctuations in high tech because investment in this region, which accounts for 25 percent of total investment, is high-tech intensive. In contrast, investment in Western Europe, which accounts for 68 percent of total investments—is mainly in traditional industries, among which global volatility is less severe.

The trend in the earnings of Israeli firms' foreign subsidiaries changed in 2003, as positive earnings of \$ 0.3 billion were amassed after two years of cumulative losses of \$ 0.8 billion. The turnaround is composed of smaller losses in electronics and telecommunications, stronger earnings in pharmaceuticals (the most profitable industry), and unchanged earnings in construction. These trends seem to have continued in 2004, in view of the continued high-tech recovery and the continued boom in foreign real estate.

Purchases of foreign subsidiaries from Israeli companies totaled \$ 1.2 billion in 2003. This accounted for only 10 percent of external sales turnover, in contrast with the situation in the 1990s, when most external sales turnover originated in exports from Israel. These data also illustrate the change in the purpose of direct investment, from marketing systems to manufacturing. Sales turnover in Western Europe and North America is similar at around \$ 4 billion. In Western Europe, 80 percent of investment is made in marketing and holding companies and 14 percent is in manufacturing firms. In North America, in contrast, the respective proportions are 33 percent and 45 percent. In Western Europe, much marketing is performed via marketing systems owned by Israeli firms; in North America, most marketing is handled by local agents. The reason for the difference is that independent marketing systems are less expensive to acquire in Western Europe than in North America (Figure 1.3b.3).

Figure 1.3b.3
Balance of Business-Sector
Investment in Western Europe and
North America, by Type of Activity,
December 2004 (\$ billion)



SOURCE: Based on company reports.

c. Portfolio investment

The trading portfolio of the private sector (shares and negotiable bonds) increased in 2004 by \$ 2.2 billion (16 percent) and came to \$ 15.9 billion at year's end—\$ 11.7 billion in bonds and \$ 4.2 billion in shares. The net investment flows were \$ 1 billion of which \$ 0.9 billion were in bonds and \$ 0.6 billion in shares (Figure 3.2.1).

The trend in the private sector's portfolio investments may be divided into two subperiods: \$ 1.2 billion in investment during the first quarter of the year and the cessation of investment from April on (Table 1.3.6).

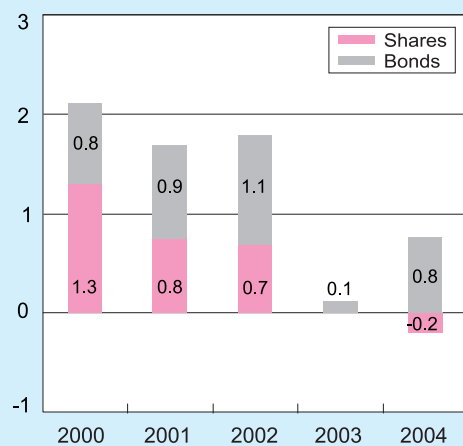
Table 1.3.6
Investments of the Private Sector in Tradable Securities Abroad according to Sub-Sector, 2000 to 2004

	2000	2001	2002	2003	2004		Total
					Jan. to Mar.	Apr. to Dec.	
Total ^a	2.2	1.1	2.5	2.5	1.2	-0.2	1.0
<i>Of this:</i> bonds and shares	1.1	1.6	2.7	2.8	1.0	0.5	1.5
Households	0.7	0.0	0.8	1.0	0.9	-0.3	0.6
Institutional Investors	0.1	0.3	0.3	0.8	0.1	0.6	0.7
Business sector	0.6	1.7	1.8	0.1	0.3	0.3	0.6
Banking sector	-0.6	-0.4	-0.2	1.0	-0.3	-0.1	-0.4

^a Including transactions in forwards and futures.

SOURCE: Reports of the banks, companies and institutional investors, data of the Ministry of Finance and processed data of the Department for Economic Activity in Foreign Currency.

Figure 1.3b.4
Business-Sector Flow of Portfolio Investment Abroad, 2000–04
(\$ billion)



SOURCE: Based on bank and company reports.

The various subsectors of this sector behave differently in regard to their portfolio investments due to different short- and long-term considerations.

The total portfolio investment of the **business** subsector increased by \$ 0.6 billion (13 percent) to \$ 5.3 billion, nearly all in bonds. The investment flow in bonds was \$ 0.8 billion (Figure 1.3b.4), mainly in the first third of the year. In subsequent months, as other subsectors realized bond investments, the business subsector reduced its investments but did not cross into realization. The changeover from deposits to bonds that occurred in 2003 did not continue in 2004, as investment in both vehicles increased.

From April on, households stopped investing abroad due to weakness in foreign markets and the appreciation of the NIS against the dollar.

The **household** subsector, composed of individuals who transact directly or means of mutual funds, invested only \$ 0.6 billion in tradable securities in 2004 as against \$ 1 billion in 2003. The investment balance climbed to \$ 5.1 billion (up 24 percent) by year's end (Figure 1.3b.5). Households make most of their bond transactions by means of mutual funds due to the relative complexity of managing investments in this instrument. Investments in shares, in contrast, are also carried out directly. In the first quarter of the year, households invested \$ 0.9 billion of which 80 percent was carried out by means of mutual funds, pursuant to the trend that began in late 2003. From April on, the investment flows stopped and \$ 0.4 billion in realizations ensued due to weakness in foreign capital markets and the global depreciation of the dollar. Generally speaking, Israeli households followed the market trend as opposed to preceding it. Furthermore, they did not acquire Exchange Traded Funds (ETFs) on leading foreign indexes to any large extent, even though the tax rate on these certificates had already been cut. This suggests that the public lacks access to and awareness of the changing investment possibilities. Another factor that affected the funds' external investments this year, as before, was the expiration of Gilboa bonds, of which the mutual funds held \$ 0.5 billion. Some of these funds became foreign-investment funds; others preferred to acquire domestic forex-indexed assets against the backdrop of issues of forex-indexed instruments replaced these bonds without shocks. According to data on investments by individuals who have extensive holdings abroad, it seems that funds on deposit were reinvested in foreign bonds in the first quarter of the year, pursuant to the trend that began in the last quarter of 2003 in view of yield differentials that favored bonds.

Figure 1.3b.5
Household-Sector Flow of Portfolio Investment Abroad, 2000–04
(\$ billion)

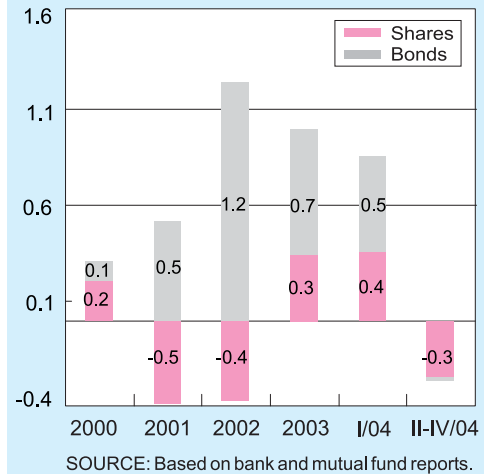
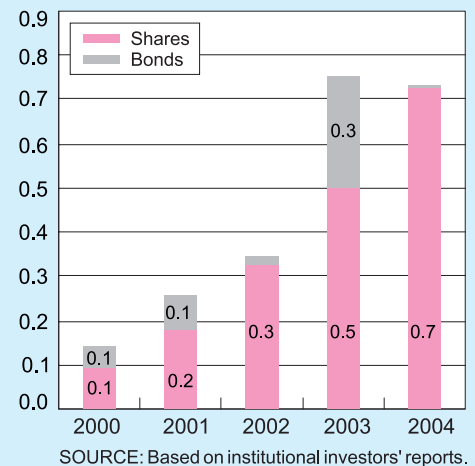


Figure 1.3b.6
Institutional Investors' Flow of Portfolio Investment, 2000–04
(\$ billion)



The **institutional-investor** subsector, composed of insurance companies (in their defined-contribution life-insurance plans), provident funds, pension funds, and advanced-training funds, invested \$ 0.7 billion in negotiable securities in 2004—nearly all in shares—as against \$ 0.8 billion in 2003 and brought the balance of these instruments to \$ 2.5 billion at year’s end (Figure 1.3b.6). Israel’s institutional entities invested 3.5 percent of total assets in foreign assets as against 20 percent in the OECD countries. This rate is expected to rise in future years as the portfolio-adjustment process continues.

Although the portfolio-adjustment process of Israel’s institutional investors is a matter of long-term strategy, short-term developments affect its pace. For example, the weakness of the American stock markets in the first three quarters of the year and the appreciation of the NIS slowed the flows of portfolio investment by provident funds and led to realizations by insurance companies. The equalization of tax rates on institutional investors’ income from Israeli and foreign securities is one of the main factors that determine the pace of the portfolio adjustment. Insurance companies, which have been exempt from tax on their gains from foreign securities since they have been allowed to invest abroad, already hold 7.3 percent of their assets abroad. Although this rate is low by international standards, it far surpasses that of the provident funds, which keep only 2.5 percent of their assets abroad and will be exempted from tax on foreign securities only from the beginning of 2005. Against this background, the provident funds began to invest in August 2004 in foreign securities by acquiring ETFs on foreign share indices due to a regulation that exempted them from tax on these instruments this year. The new pension funds are also noteworthy. Although their external investments are negligible for the time being, considerations of portfolio diversification coupled with scanty offerings in the domestic capital market—for reasons including the termination of issues of earmarked bonds—are creating the potential of large-scale external investment by these entities, which have \$ 0.8 billion in annual accrual, in future years. Furthermore, the privatization process is expected to step up the pace of external investing by shifting ownership of pension funds to insurance companies, which have acquired experience in international capital markets.

As stated, the **elimination of tax discrimination** between Israeli and foreign securities in January 2005 is expected to have an upward effect on the share of foreign securities in the portfolios of provident funds, pension funds, and households. According to a study by the Foreign Exchange Activity Department (see Box 2.1 in the section on the NIS-Forex Market) that examined the effect of the tax reform through the prism of an investment-portfolio model, Israeli investors, like investors elsewhere, are strongly predisposed to invest in domestic shares but are less inclined to invest in bonds. According to the study, the reform will increase bond investments by \$ 10 billion, mostly in purchases by provident and pension funds—which will be totally tax-exempt—and will boost investment in shares by \$ 1.5 billion. The experience of insurance companies, which have been tax-exempt since they were allowed to invest abroad, suggests that provident and advanced-training funds will

The pace of external investment by institutional investors slowed in view of weakness in foreign markets and the appreciation of the NIS.

Although the elimination of tax discrimination is expected to boost external investment, experience suggests that the pace of the adjustment will be slow.

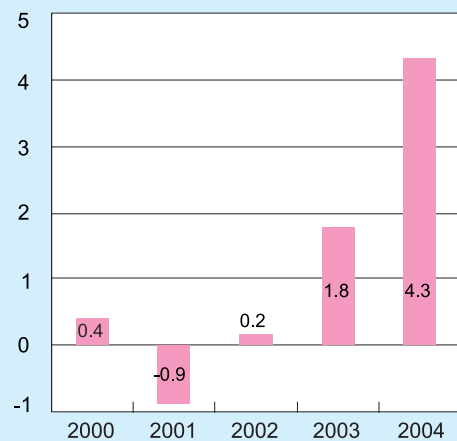
make the adjustment more slowly and that the pace of their adjustment will be affected by short-term developments.

d. Other Investments

The banking system speeded up the transfer of surplus sources to external deposits.

“Other investments” are composed of external deposits and credit to nonresidents. Total **external deposits** of the private sector increased by \$ 5.6 billion in 2004 and came to \$ 26 billion. The **business subsector**, which increased its depositing by \$ 1 billion, includes subsidiaries of multinational firms that invest their surplus liquidity in view of the global policy considerations of the parent company. This subsector also includes firms that export and that issued abroad, which built up their external deposits this year in view of increases in exports and issues. Notably, most deposits of the business sector are created by high-tech companies, which do most of their activity in forex, keep their books in forex, and are influenced mainly by forex yield spreads between Israel and abroad. This year, companies in the financial sector also stood out, depositing large quantities of forex abroad as backing for forex-indexed securities issued to residents. (For further discussion, see Part B of the NIS-Forex Market section of this Report.). The **banking subsector**, which increased its deposits by \$ 4.3 billion (Figure 1.3b.7), uses such deposits mainly for the management of its liquidity in forex, which it derives, among other things, from excess forex sources that it does not put to domestic use. The banks’ heightened external-deposit investment this year traces mainly to an increase in sources due to accrual in forex-denominated resident deposits, repayment of forex-denominated credit—mainly by business borrowers in view of exchange rates that they considered low—and repayment of credit by nonresidents. (For details, see Part B of the NIS-Forex Market section of this Report.) **Households** withdrew negligible sums from their external deposits this year.

Figure 1.3b.7
Banking-Sector Investment Flow into Deposits Abroad, 2000–04
(\$ billion)



SOURCE: Based on bank reports.

Outstanding external **customer credit** by the business sector rose by \$ 0.6 billion (8 percent) and amounted to \$ 8.2 billion at the end of September 2004. One reason for the increase was the upturn in exports, although outstanding credit did not expand as quickly as exports.

Analysis of the behavior patterns of large firms, whose outstanding customer credit accounts for 60 percent of total domestic customer credit, shows that the average term of credit for export⁴ is ninety days, a month longer than the average term of credit in the domestic market. Furthermore, the term of credit to the domestic market corresponds to the business cycle and reflects the liquidity difficulties of firms during downturns and the improvement in liquidity that occurs at times of recovery. And indeed in 2004 the average term of credit declined. On the other hand, the term of export credit is not affected by the business cycle abroad and remains stable over time, evidently because Israeli firms are not large enough to dictate patterns of trade, prices, or conditions of credit. Furthermore, Israeli lenders provide longer terms of credit for export than the norm in several Western European countries, apparently due to the high share of high-tech in Israeli exports, in which the number of credit days exceeds the industry average.

e. External assets of general government

The external assets of general government increased by \$ 0.4 billion in 2004 and ended the year at \$ 27.7 billion. These assets are composed mainly of the foreign reserves of the Bank of Israel, which increased by \$ 0.8 billion during the year. General-government external assets also include other assets of the Bank of Israel and government deposits with foreign banks.

The main factors that caused the reserves to grow were interest earnings on the reserves and exchange-rate differentials between the dollar and other currencies. The interest earnings were \$ 0.5 billion, resembling the 2003 level. Exchange-rate differentials also generated \$ 0.5 billion in earnings, mostly in the fourth quarter in view of the global depreciation of the dollar, as against \$ 1.1 billion in 2003.

By authorizing an extension of the term for use of its loan guarantees to six years, the U.S. Government allowed the Government of Israel to raise less capital abroad this year than in 2003 and to issue at a level approximately equal to expenditure. Accordingly, government activity had no substantial effect on the reserves, in contrast to 2003, when government activity boosted the reserves by \$ 1.5 billion.

⁴ The average term of credit is the ratio of average outstanding credit to the flow of exports during the relevant period, expressed in days.