Overview and Policy

Israel's external and foreign-exchange activity in 2003 reflects the trend of stabilization and improvement in the NIS/foreign-currency market and the balance of payments, as well as in Israel's financial stability, which is connected with both of them. This trend is the result of the amelioration of the main processes which had caused the volume of activity in the balance of payments to contract and undermined external financial stability in 2001 and 2002. The decline in economic activity was checked, and towards the end of 2003 the first signs of recovery were evident. Although the conflict with the Palestinians continued, it was less intense than in previous years; the credibility of macroeconomic policy—which had been eroded in 2002—was rehabilitated, due to both the government's firm commitment to the downward path of the deficit and the government debt and the Bank of Israel's cautious and considered prosecution of monetary policy. The global economic slowdown ceased, and there were indications that the slump in the high-tech industry and financial markets was coming to an end. These processes were expressed in the appreciation of the NIS vis-à-vis the dollar and its stabilization against the currency basket, alongside a reduction in exchange-rate risk, which reverted to the level evident at the end of 2001.

The current account of the balance of payments was almost balanced in 2003—compared with a deficit of 1.3 percent of GDP in 2002—for the first time in ten years. This was achieved by virtue of the rise in goods and services exports, the acceleration in global economic activity, and the decline in imports of investment and durable goods as a result of the protracted economic slowdown.

The decline in the *financial account* that had characterized the last two years halted, while the extent of direct foreign investment doubled, bringing it back to the level that had prevailed before the surge in the high-tech industry.

The course of the exchange rate in 2003 reflects the considerable contribution of *nonresidents* to the strengthening of the NIS. This is the outcome of their activity in short-term instruments, primarily derivatives, and their long-term activities, i.e., direct and portfolio investment.

The activity of nonresidents was affected both by domestic developments, expressed in the decline in the level of risk ascribed to Israel's economy, as well as in global trends. The elimination of the threat from Iraq, the receipt of the US loan guarantees, the establishment of a new government, and the formulation of a new economic program with tighter fiscal control, together with the global process of the diversion of capital to emerging markets where interest rates are relatively high, against the backdrop of falling yields in the advanced economies and change in the perception of global risk—all led to short-term capital inflow in 2003:II, expressed in marked local-currency appreciation alongside the weakening of the dollar against most world currencies. The contraction of the yield gap between Israel and the advanced economies led to the cessation of this trend in the second half of the year. Forecasts by foreign financial entities of expected NIS appreciation during 2003 (in contrast to predictions by Israeli forecasters), and the pattern of activity of nonresidents in the NIS/foreign-currency market in the first half of the year, indicate that they succeeded in rapidly identifying the change in the market fundamentals and altering the direction of their short-term NIS exposure—switching from the position against the NIS which they had held in the last few years to the reverse in the last three quarters of 2003. These developments attest to the fact that against the backdrop of the process of Israel's integration into the global economy, the correlation between Israel and emerging markets has soared this year with respect to the exchange rate, capital flows, and the levels of exchange-rate and country risk.

The improvement in *financial stability*, which is associated with economic activity vis-à-vis abroad and in foreign currency, was expressed in various parameters of the NIS/foreign-currency market as well as in Israel's credit risk: *exchange-rate risk*, measured by the implied volatility of NIS/dollar options, fell during the year and reverted to its end-2001 level; this decline reflected *inter alia* the restoration of macroeconomic credibility, particularly in the context of the marked reduction in the Bank of Israel's key interest rate in the course of 2003, leading to a 3.5 percentage-point decline in the NIS/dollar interest-rate differential. At the same time Israel's *credit risk*, which is measured from the risk premium implicit in prices of government bonds traded abroad, contracted, in accordance with the global trend of a decline in the country risk attributed to emerging markets. The backdrop to the improvement in these parameters of financial stability and the strengthening of the NIS was the marked amelioration in several long-term variables. These included the *US government loan guarantees*, which enabled Israel's government to borrow $ 9 billion; the improvement in Israel's *basic account*, reflecting the balanced situation in the current account and the rise in foreign investment in Israel; Israel's *net external debt*, which has become a net surplus since 2002 and reflects Israel's position as a net lender to other economies; and the *exposure of the business sector* to exchange-rate risk, which declined alongside a rise in the heterogeneity of this sector, also serving to enhance financial stability.

The improvement in the basic account, reflecting the long-term supply of foreign currency in the NIS/foreign-currency market, exerted basic pressure for appreciation—after this account contracted continuously in 2001 and 2002 and became negative. This trend makes the market less sensitive to the effect of short-term more volatile exchange-rate changes.

During 2003 the process of perfecting the *NIS/foreign-currency market* persisted, expressed *inter alia* in the issuance of new financial instruments, together with the contraction of the supply of local-currency assets as a result of the expiry of dollar-indexed government bonds (*Gilboa*). The expansion of this market, which is the deepest and most liquid of Israel's financial markets, appears to have been checked, however. In the last ten years this market has been gradually perfected and deepened, against the backdrop of the liberalization of foreign-exchange control, increased flexibility in the exchange-rate regime, and greater activity of foreign entities. The decline in the extent of currency conversions, increase in market spreads, and reduction in exchange-rate risk call the long-term path of this market into question. While these trends may express the conclusion of the development process, they may also reflect structural problems, such as the extent to which the domestic market is developed and discrepancies in trading patterns between domestic and foreign banks. Particularly notable is the low level of *exchange-rate risk*, by both historical and international standards, in view of assessments regarding its expected increase as a result of the long-term structural changes mentioned above. The future trend of this variable is highly significant with regard to monetary policy, because its decline offset the effect on the exchange rate of the marked interest-rate cuts made during the year.

Against the backdrop of the growing openness of the economy, its greater sensitivity to external shocks, and the fact that it is subject to continuous scrutiny by global financial markets, the prosecution of responsible and considered macroeconomic policy, in accordance with the standards currently prevailing in developed economies, assumes especial importance, in addition to the creation of the conditions that will enable the economy to continue developing and becoming more perfect. Note, in this context, the need to remove the last obstacle that will enable the economy to operate with a completely free exchange rate and full liberalization—the *exchange-rate band*. Although this band, which has widened over the last ten years, is no longer effective, it embodies a potential distortion in the perception of risk by market players: by providing costless insurance against exchange-rate risks it constitutes a negative incentive to the further development of the market, and especially to the development of derivatives aimed at managing the risk of the business and financial sectors. The annulment of the exchange-rate band and the shift to a floating exchange rate regime will prevent the generation of distortions of this kind, enabling the exchange rate to operate as a shock-absorber, as is customary in developed economies worldwide, while making it more flexible, thus also bringing it into line with some emerging markets.

The private sector's exchange-rate-risk management is a pivotal part of the process of market development at a time of transition to a floating exchange rate. In the long term, as a result of the convergence of the domestic inflation rate in recent years to the levels evident in advanced economies, the rate is expected to vary without a clear-cut trend—in contrast to the constant and ongoing trend of depreciation that prevailed until the late 1990s. In this situation the allocation of responsibility for exchange-rate risk between the central bank and the private sector requires the former to act to attain price stability, which should serve to reduce the long-term volatility of the exchange rate, and the latter to manage risk in a thoughtful and systematic way, in order to minimize the effect of short-term fluctuations on business outcomes. Despite the rapid development of the derivatives market, the increased volume of use, and the development of a variety of instruments for different players and uses, the intensity with which the business sector uses hedging instruments is still low relative to the extent of its activity and the exposure to exchange-rate risk implicit in this. One of the main problems precluding greater use of instruments intended to hedge against risk is the way they are currently presented in financial statements, which constitutes a negative incentive to using them. Consequently, the authorities should take the initiative to regulate matters in such a way as to bring about a more efficient distribution of risks, contributing thereby to the greater stability of both the business sector and the market as a whole.

At the beginning of 2003 the last remaining (and ineffective) restriction in the area of foreign-exchange control—the quantitative restriction on investment abroad by institutional investors—was removed. This concluded the *process of the liberalization of foreign exchange* which began over ten years ago and embodies marked economic benefits. It constitutes an important part of the macroeconomic strategy of increasing the openness of the economy, enabling the fulfillment of its growth potential. The advantages implicit in increased integration with world financial markets are expressed in the contribution of foreign entities to the greater efficiency of the markets, the part played by foreign investment in the development of the economy, as well as in the improvement of the process of allocating the public's asset and liability portfolios. This process is still in its initial stages, and the foreign securities component of the public's asset portfolio is still small by international standards, despite expectations of its rapid expansion. These expectations were based on the assessment that the process of interest-rate cuts has virtually concluded, on the interest-rate differential vis-à-vis abroad, which is low by historical standards, and on the completion of the process of liberalization. The low proportion of investment in foreign securities is explained by tax discrimination between profit on investment in Israel and abroad, and also apparently by the home bias of domestic entities—i.e., the tendency to invest less in foreign assets than is derived from the optimum portfolio, based on yield and risk considerations. The regulations regarding tax reform, which went into effect at the beginning of 2003, appear to have reduced the tax discrimination between investment in foreign-currency assets and in assets abroad, on the one hand, and in local-currency assets, on the other, but the existence of interim arrangements during the year has limited the effect of the changes on residents' investment considerations. It will be possible to utilize all the benefits implicit in the liberalization process once the tax discrimination is completely annulled. This should serve to optimize the allocation of the public's portfolio, particularly by institutional investors, notably increasing the foreign-asset component—in accordance with the experience of the advanced economies—and significantly reducing the sensitivity of institutions to fluctuations in the domestic capital market, which is shallow in relation to the extent of the assets they manage.

In order to achieve a policy aimed at attaining the stability of prices and the financial markets it is necessary to analyze the preconditions for this—based *inter alia* on past experience—as well as the factors which create and increase vulnerability and the processes which undermine stability. Constant monitoring is required in order to identify such processes at the earliest possible date, while distinguishing temporary negative trends from the onset of a damaging process. Special importance is attached to the sectoral analysis of economic activity—identifying the patterns of behavior of the various sectors, chief among them the major financial players and households, at times of crisis and of calm, and monitoring changes in their activity. The basis for monitoring and analysis of this kind is extensive, detailed, and up-to-date data. In the last few years, concurrent with the liberalization process, the *Foreign Exchange Activity Department* has constructed extensive and detailed databases of economic activity vis-à-vis abroad and in foreign currency. These make it possible to analyse monetary policy needs on an ongoing basis, track the stability of the economy, and identify focal points of vulnerability and processes in which stability is undermined. The data are processed within the Department and published from time to time with a minimal lag, with the object of improving the quality and accessibility of the information available to the players in the financial markets. The Department also publishes surveys of various kinds, press releases, and studies in the areas in which it specializes, as well as holding meetings intended to create channels of direct communication between it and the various market players. This is done in the realization that transparency in the markets makes them more perfect, thereby increasing financial stability.

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This report has three parts. The first analyzes market developments within the accepted international framework of the *balance of payments*, namely, economic activity vis-à-vis nonresidents in foreign and local currency; this includes activities in both the current and financial accounts of the balance of payments, as well as Israel's international investment position (IIP).

The unique nature of Israel's economy and the prominent part played by the exchange rate require a separate framework for analyzing it so that it is possible to identify all the forces acting on the exchange rate. The second part of this report deals with *NIS/foreign-currency activity*, including the foreign-currency activity of the various resident sectors (in the denominated and indexed segments, vis-à-vis nonresidents, and among sectors), assets and liabilities, and nonresidents' activity in local-currency assets and liabilities (including NIS/foreign-currency forward transactions).

The liberalization process has exposed Israel's economy to international capital movements and made it more sensitive to external financial risks, so that it is necessary to continually monitor its external financial stability; *financial stability* is analyzed in the third part of this report, in the context of activity in the NIS/foreign-currency market and vis-à-vis abroad, the external debt, and credit risks.