Chapter 6

The Balance of Payments

1. MAIN DEVELOPMENTS

Accelerated growth in exports marked 1992, together with the continued rapid expansioı of imports which had begun in 1990. The civilian import surplus amounted to som $5.4 billion, representing 8 percent of GNP. The increase in foreign trade reflects th economy's greater openness to world markets. Unilateral transfers rose by $20 million, reaching $7 billion. The current account deficit of $300 million was converte into a surplus of $100 million. The net external debt/GNP ratio continued its decline falling to 24 percent in 1992, from about 27 percent in 1991.

Exports (excluding capital) rose in volume by some 15 percent, after a 1 percent fall iı 1991, the year of the Gulf war, and a 2 percent increase in 1990 (Table 6.2). Industria exports (excluding diamonds) grew in volume by some 11 percent in 1992, with a 2: percent rise in hi-tech products. Service exports also rose; prominent in this area was th growth in the number of tourist arrivals, from 1.1 million in 1991 to 1.8 million in 1992 after a sharp decline in the preceding year due to the Gulf crisis. This was reflected in rise of about $600 million in income from tourism. The increase in exports resulted fron strong world demand for Israel's products and services, and from improved capacit utilization.

Civilian imports continued their rapid volume growth, rising by 13 percent (excludin capital). Imports of intermediates (excluding fuel and diamonds) increased by 1: percent, and consumer goods by 20 percent. This sustained the rapid growth of 1991 when imports of intermediates (excluding fuel and diamonds) and consumer good increased by 15 and 21 percent respectively. The rapid expansion of imports o intermediates is attributable to the continued increase in production, while that o consumer goods reflects greater demand for consumer durables. There was a slowdowı in the growth of imports of investment goods—plant and equipment—which rose b only 4 percent, after increasing by 22 and 28 percent in 1990 and 1991 respectively.

The slower growth in domestic use of resources and increase in demand for tradable (compared to nontradables), with the relaxation of pressure in the housing marke weakened the forces causing real currency appreciation which have been in evidence iı recent years. Towards the end of 1992 the decline in the export/domestic output pric ratio was reversed (see Chapter 2).

Table 6.1
Selected Balance-of-Payments Indicators, 1979–92

	1979–83	1984–87	1988	1989	1990	1991	1992
Billions of current $							
Total current account	–1.2	0.2	0.0	1.2	0.6	–0.3	0.1
Adjusted current account[a]	–1.4	0.2	0.4	1.1	0.4	–0.5	0.2
Import surplus							
Total	4.1	4.5	5.2	3.9	5.4	7.1	6.9
Civilian[b]	2.6	2.8	3.1	2.7	3.9	5.1	5.4
Civilian, excl. capital services	1.8	1.1	1.5	1.3	2.6	4.2	4.3
Net unilateral transfers							
To public sector	1.7	3.5	3.2	3.1	3.8	4.4	4.1
To private sector	1.1	1.1	1.7	2.0	2.1	2.3	2.9
Implied private capital imports[c]			–2.1	0.7	0.7	0.0	–2.1
External debt							
Net	13.3	18.1	18.6	16.3	15.7	15.5	15.1
Gross	24.1	30.5	31.5	31.5	32.8	33.2	33.6
Foreign reserves	3.7	4.5	4.3	5.6	6.5	6.4	5.3
Annual change, percent (volume)							
Exports[d]	3.7	6.4	–3.1	5.7	5.0	1.6	15.1
Civilian imports[d]	10.8	3.4	–1.2	2.1	10.1	15.2	13.3
World trade	1.9	5.6	9.0	7.1	5.2	3.5	4.7
Exchange rate							
Against the dollar	0.0199	1.14	1.60	1.92	2.02	2.28	2.46
Against the 5-currency basket	0.0193	1.12	1.72	2.00	2.21	2.48	2.73
Net external debt as percent of							
GNP	59.5	65.5	43.4	37.5	29.5	26.6	23.5
Exports	136.3	155.3	120.0	97.4	85.4	83.6	72.6
Relative prices (1980 = 100)							
Imports/domestic resource use[e]	94	84	73	73	71	65	63
Exports/domestic resource use[e]	96	85	74	75	72	70	69
Terms of trade[f]	102	114	121	119	116	122	123

[a] Adjusted for advances on defense imports..
[b] Excluding direct defense imports.
[c] See Table 6.8.
[d] Excluding diamonds and capital services.
[e] Implicit price index of imports (exports) ÷ by implicit price index of domestic use of resources (from the national accounts). Excludes direct defense imports.
[f] Excluding capital services, diamonds, and direct defense imports.
SOURCE: Based on Central Bureau of Statistics data.

Table 6.2
Goods and Services Account, 1988–92[a]

	$ million				Annual change, percent					
					Price			Quantity		
	1989	1990	1991	1992	1990	1991	1992	1990	1991	1992
Imports										
Goods excl. fuel and diamonds[b]	8,440	10,157	12,097	13,399	3.7	-3.3	-1.1	16.1	23.2	12.0
Fuel	1,247	1,535	1,474	1,713	22.5	-23.3	-4.8	0.5	25.2	22.1
Diamonds	2,869	2,895	2,558	2,910	13.5	-0.5	5.6	-11.1	-11.2	7.8
Services[c]	3,875	4,431	4,700	5,186	16.0	8.0	-1.2	-1.5	-1.8	11.6
From Judea-Samaria and Gaza	775	961	901	1,171	4.3	0.8	3.9	18.9	-7.0	25.2
Subtotal	**17,206**	**19,979**	**21,730**	**24,380**	**8.9**	**-2.4**	**-0.4**	**6.6**	**11.4**	**12.6**
Capital services	2,661	2,739	2,539	2,505						
Direct defense imports	1,204	1,501	1,973	1,466						
Total imports	**21,071**	**24,220**	**26,241**	**28,351**						
Exports										
Goods, excl. diamonds[b]	7,518	8,370	8,319	9,092	5.5	-1.4	-0.3	5.5	0.8	9.6
Diamonds[d]	3,027	3,054	2,728	3,086	15.1	3.0	-0.3	-12.3	-13.2	13.4
Services[c]	4,647	4,975	5,257	6,507	5.3	6.7	-0.5	1.6	-1.0	24.4
To Judea-Samaria and Gaza	742	967	1,224	1,420	7.3	3.4	2.5	21.5	22.3	13.1
Subtotal (excluding capital)	**15,934**	**17,367**	**17,528**	**20,105**	7.1	1.9	-0.2	1.7	-1.0	14.9
Capital services	1,268	1,496	1,660	1,391						
Total exports	**17,202**	**18,863**	**19,188**	**21,496**						

Trade deficit[b]				
Excl. diamonds and fuel imports	922	1,787	3,778	4,308
Current surplus, diamonds	159	159	171	176
Total trade deficit	2,011	3,163	5,082	5,845
Surplus on services account[c]	771	544	556	1,322
Civilian import surplus[e]	1,273	2,613	4,203	4,275
Capital services imports, net	1,393	1,243	878	1,114
Civilian import surplus	2,665	3,856	5,081	5,389
Total import surplus	**3,869**	**5,357**	**7,054**	**6,855**

[a] Imports c.i.f., exports f.o.b.

[b] Excluding Judea-Samaria and Gaza.

[c] Excluding capital services and Judea-Samaria and Gaza.

[d] See Table 6.3 for breakdown of diamond exports.

[e] Excluding capital.

SOURCE: Based on Central Bureau of Statistics data.

The cumulative current account for the period of mass immigration (1990–92) shows that in the immigrant-absorption process insufficient use was made of available external sources, as is seen in the lower net debt/GNP ratio. This reflects the fact that investment was lower than the desired and planned level for immigrant-absorption programs.

The private-sector import surplus rose by only $ 100 million. As this was accompanied by an increase in unilateral transfers to this sector of some $ 500 million, the current-account deficit of the private sector fell. Whereas in 1991 the private sector purchased foreign currency from the Bank of Israel roughly equivalent to its current-account deficit, in 1992 it bought more than the deficit, resulting in a capital export of some $ 2.1 billion.

This turnaround was caused by a combination of factors. Due to the liberalization of foreign-exchange control, net investment abroad rose from $ 760 million to $ 1.4 billion, and deposits were transferred from the Bank of Israel to banks abroad. The reduction in the banks' deposits with the Bank of Israel was made possible mainly by the reduced liquidity requirement for resident restitution deposits, which contracted by some $ 600 million (compared to a decline of $ 140 million in 1991). Foreign-currency deposits with the Bank of Israel fell throughout 1992, with the reduction totalling some $ 1 billion ($ 700 million in 1991). Expectations of high yields towards the end of 1992, arising from the combination of expansionary monetary policy and the exchange-rate policy, boosted demand for foreign currency.

The foreign reserves fell from some $ 6.4 billion at end-1991 to $ 5.3 billion at end-1992, with most of the fall occurring in the second half of the year. The reserves rose again at the beginning of 1993 with the receipt of the US government loan guarantees.

In December 1991 the exchange-rate system was changed, the midpoint rate being adjusted daily at a predetermined rate. In November 1992 the midpoint rate was raised by 3 percent, and the annual rate of change (the slope) was reduced from 9 to 8 percent. Between January and November there was depreciation of about 9.5 percent against the currency basket, equivalent to an annual 11 percent—the rate which had prevailed since 1986. Towards the end of 1992 the actual rate of depreciation was accelerated (as part of the policy of the sloping band exchange rate), yielding a total annual rate of 16 percent against the currency basket.

As part of the process of increasing exposure to foreign trade, enabling a switch in imports from expensive to cheaper countries, Israel signed a trade agreement with the EFTA group of countries in 1992, effective from January 1993, and proceeded with the gradual exposure of the economy to imports from 'third countries' (South-East Asia, South America, and Eastern Europe) with which Israel does not have trade agreements. The objective of the trade liberalization policy is to prevent the misdirection of investments into goods whose production is profitable only by virtue of protective policies. Recently, pressure to slow down the exposure program has been exerted by a number of industries, and in textiles and clothing the government acquiesced, extending the process by two years. Such deviations from the original program may well call its credibility into question, thus hampering the efficient channeling of investment.

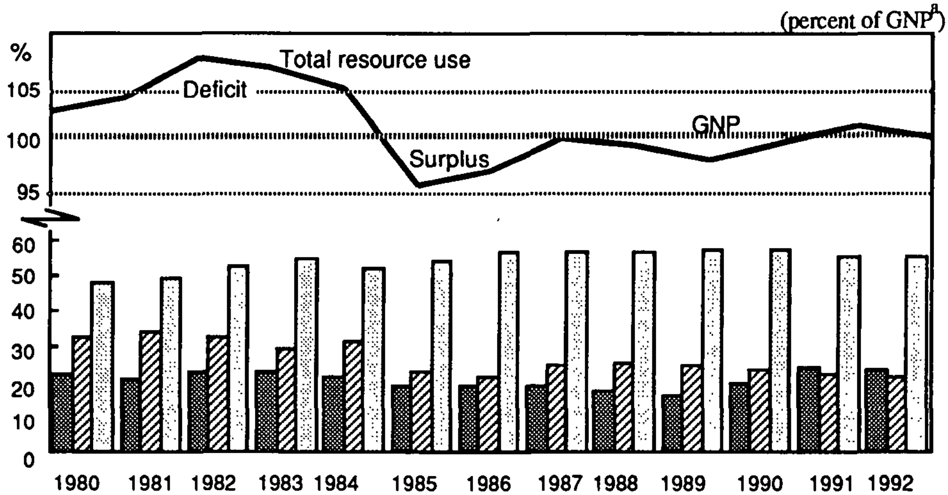
2. THE CURRENT ACCOUNT

The current account, output, and domestic use of resources

Following two years of reduction of the surplus, the current account (adjusted for advance payments on defense imports) showed a $ 500 million deficit in 1991; in 1992 the trend was reversed, and the adjusted current account showed a surplus of some $ 150 million. This is in line with the growth of the civilian import surplus (excluding interest

Figure 6.1
Domestic Use of Resources and the Adjusted Current Account, 1980–92

(percent of GNP[a])



Deficit or surplus in adjusted current account.

— Total resource use—gross investment and consumption *less* unilateral transfers from rest of world adjusted for advances. The difference between domestic resource use and GNP is the surplus or deficit on current account.

Private consumption *less* net unilateral transfers to the private sector.

Public consumption *less* net unilateral foreign transfers to the general government, adjusted for advances.

Gross investment.

[a] At official exchange rate.

SOURCE: Based on Central Bureau of Statistics data.

payments) of recent years, and its slowdown in 1992, during which it increased by only $ 100 million (excluding capital services), after rising by $ 1.6 billion in 1991 (Table 6.1); it now represents 8 percent of GNP.

Table 6.3
Merchandise Exports (f.o.b.), 1989–92

	$ million				Annual change, percent					
					Price			Quantity		
	1989	1990	1991	1992	1990	1991	1992	1990	1991	1992
Agricultural exports	527	656	643	551	10.2	−1.2	−12.7	13.1	−0.8	−1.8
Citrus	*132*	*180*	*150*	*117*	2.1	8.3	−11.5	34.2	−23.4	−12.1
Other	*395*	*476*	*493*	*434*	13.4	−3.6	−13.0	6.2	7.6	1.3
Industrial exports[a]	7,068	7,894	7,884	8,863	5.2	−0.9	1.4	6.2	0.8	10.9
Metals, machinery, electronics	*3,229*	*3,492*	*3,504*	*4,024*	2.8	−0.6	1.9	5.2	0.9	12.7
Chemicals, rubber, plastics	*1,579*	*1,818*	*1,834*	*1,994*	7.3	−2.4	−1.7	7.3	3.3	10.5
Other	*2,259*	*2,584*	*2,546*	*2,846*	7.2	−0.4	2.9	6.7	−1.1	8.6
Polished diamonds (net)	2,704	2,783	2,469	2,641	14.6	3.3	0.0	−10.2	−14.1	7.0
Unpolished diamonds (net)	323	271	259	445	20.9	0.0	−1.9	−30.6	−4.4	75.1
Ships and aircraft	75	22	32	13						
less Returned exports	27	24	67	84						
Net exports[b]	**10,669**	**11,603**	**11,219**	**12,429**	7.9	−0.4	−0.3	0.8	−3.0	11.1
Balance-of-payments adjustments	−124	−179	−172	−251						
To Judea-Samaria and Gaza	516	709	976	1,103	5.9	2.9	2.2	29.7	33.8	10.6
Total	**11,061**	**12,133**	**12,024**	**13,282**	7.8	−0.1	−0.1	1.8	−0.8	10.6
Total excl. diamonds and exports to Judea-Samaria and Gaza	7,518	8,370	8,319	9,092	5.5	−1.4	−0.3	5.5	0.8	9.6

[a] Excluding diamonds, ships, and aircraft.
[b] As per foreign trade data.
SOURCE: Based on Central Bureau of Statistics data.

The current-account deficit represents the gap between domestic investment and savings. The transition to current-account surplus in 1992 reflects the slower growth of investments than of savings (from all sources, including transfers from abroad). Since 1992 was a year of immigrant absorption, it would seem that a more vigorous economic policy could have been pursued to increase private-sector investment at a faster rate, compatible with sustainable growth and based on economic activity in the private sector.

The increase in domestic resource use has persisted since 1990, due mainly to the influx of immigrants, which increased present and expected demand. Private consumption demand continued to rise rapidly, by about 8 percent in 1992, but the annual rate of growth of investment dropped from some 34 percent in 1990 and 1991 to only 8 percent.

The immediate demand resulting from immigrant-absorption was by its nature mainly for nontradables, specifically housing and services, and the composition of demand contributed to an increase in prices of nontradables relative to tradables. Since the 1985 economic stabilization program (ESP), the process of real appreciation has reflected certain rigidities, including wage rigidities, despite the rise in unemployment. With the contraction in government-initiated residential construction (in which there is a large nontradable component), and the switch in demand to tradables, the pressure for real appreciation eased. Although real appreciation in 1992 was slightly higher than in 1991, there are some indications that this trend was checked during the year.

In a small economy such as Israel's, the size of the domestic market limits the opportunities to use economies of scale to foster growth. Exports make it possible to realize the potential inherent in factors of production and economies of scale, hence their vital role in achieving sustainable growth. The rigidities referred to above have contributed to real appreciation since the ESP, and have hampered the expansion of exports. However, it cannot be assumed from this that the acceleration of nominal devaluation will contribute to sustainable export growth, because it is doubtful whether this can be translated into real change. In 1992 real wage rigidities and the structural nature of unemployment limited the effect of nominal changes on real variables.

Exports

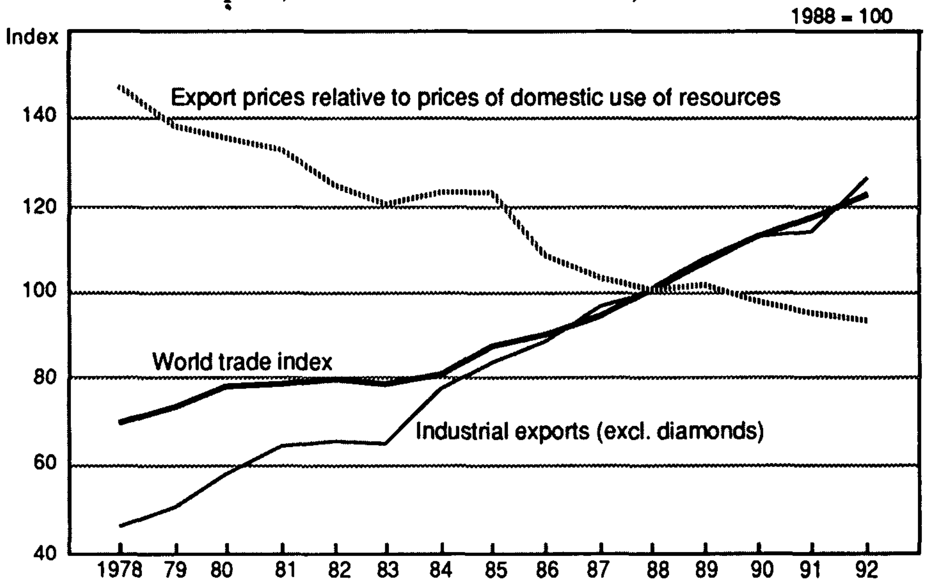
In 1991 exports were adversely affected by the Gulf war and the recession in world trade. Tourism was particularly hard-hit, with a 20 percent fall in the volume of income from tourist services relative to 1990 (when the events leading up to the war also had an adverse effect). In 1992 tourism showed a volume increase of 48 percent. The modest acceleration in world trade, from a growth rate of 3.5 percent in 1991 to 4.7 percent in 1992, also contributed to the increased demand for Israeli exports.

If 1991 and 1992 are viewed together, they show an increase in Israel's share of world trade. World trade expanded in these two years by an annual average of 4 percent, while Israel's exports (excluding diamonds and capital services) rose by 8 percent.

Although we do not have a complete explanation for the acceleration of exports, some possible causes are offered below.

The effect of changes in exchange rates between trading countries complicates the analysis of the growth of exports by destination, but a partial indicator shows that exports to markets which do not represent the main outlets for Israel's exports expanded by 22 percent (the main markets are North America, the EC, and EFTA). The rapid increase of 1992 may partly represent compensation for the effect of the Gulf crisis, which was possibly more severe in these markets; alternatively, it may reflect Israel's increased efforts to penetrate potential markets. Exports to North America grew by 11 percent in 1992, while those to Europe—still in the throes of recession—barely

Figure 6.2
Industrial Exports, Prices and World Trade Index, 1978–92



SOURCE: Based on OECD and Central Bureau of Statistics data.

increased. As a result, Europe's share of Israel's merchandise exports fell from 45 to 42 percent, while that of North America remained about 29 percent. The share represented by all other destinations increased from 27 percent in 1990–91 to 30 percent in 1992, whereas in 1989, the year before the Gulf crisis, these accounted for 31 percent of Israel's merchandise exports. Nevertheless, incomplete data on civilian exports to destinations other than Israel's main export markets suggest that these have been increasing their share in recent years.

Improved profitability of exports also appears to have contributed to their expansion in 1992. In industry, which produces about half of exports (excluding diamonds and capital services), the return on capital continued to increase, from 14–15 percent in 1990 and

1991 to 17 percent in 1992. Unit labor costs declined by about 3 percent, the same rate as in 1991. The fall in wages resulted basically from the high unemployment rate, which reduced employees' bargaining power in wage negotiations, and from the high rate of entry into the labor market, as wages of new employees are generally below the average.

Table 6.4
Changes in the Volume of Exports, 1981–92[a]

(annual change, percent)

	1981–85	1985	1986	1987	1988	1989	1990	1991	1992
Total	4.6	7.6	4.9	10.7	–2.3	4.9	1.7	–1.0	14.9
Diamonds	1.4	26.9	26.8	22.0	13.9	1.0	–12.4	–13.2	13.4
Other	6.8	5.2	1.8	8.7	–5.2	7.9	4.1	0.6	17.1
Nondiamond exports									
Industrial[b]	3.4	3.7	2.8	4.6	1.9	5.1	3.4	0.5	5.9
Agricultural	0.3	–0.5	0.7	–0.4	–1.0	0.2	0.5	–0.0	–0.1
Tourism	0.4	1.1	-2.9	1.9	–1.5	1.3	–0.9	–1.4	4.4
Other services	0.5	1.2	0.2	2.5	1.4	0.6	1.5	1.1	4.4
To Judea, Samaria and Gaza	0.1	0.5	1.2	1.0	–4.2	–0.8	1.2	1.5	1.1

[a] Total exports, excluding capital services.
[b] Including ships and aircraft.
SOURCE: Based on Central Bureau of Statistics data.

The analysis of the effect of labor-market developments on export profitability is hampered by the lack of data on output, wages, and productivity for exports; consequently, export unit labor cost is estimated on the basis of assumptions about relevant trends. Moreover, unit labor cost, which measures labor's share of output, expresses changes in profitability of production for export only if certain constraining assumptions are made regarding such factors as capital stock, taxes, and benefits.

The relative decline of input prices contributed to the profitability of production, particularly for export. In 1990–92 the cumulative increase in prices of imported intermediates was 21 percent, and that of producer prices 45 percent. The relative fall in the price of intermediates was reflected by better terms of trade for industry: prices of intermediates to industry rose by 8 percent, while those of output by 10 percent. The improvement in the terms of trade for industry was more marked than in the economy as a whole.

Gross capital stock in industry was 4.7 percent higher at the beginning of 1992 than at the beginning of 1991, and 4.8 percent higher at the beginning of 1993. This trend is consistent with preparation for the expansion of tradables production.

Imports

Imports continued to rise steeply in 1992, and total civilian imports (excluding capital) increased by 13 percent, compared to 11 percent in 1991. The fall in prices of imports relative to the prices of domestic resource use over the last two years encouraged this trend, in which the continued rapid expansion of imported intermediates and consumer durables was particularly notable. This is consistent both with the demand for foreign assets in the capital market, with new immigrants quickly using their rights to purchase durables, and production expansion, especially in industry, where the share of imported intermediates is very large. The increased demand for durables, which in Israel have a high import component, is also explained by the public's portfolio adjustment, possibly due to changes in budgetary and monetary policy (see Chapter 2).

Imported intermediates constituted some 65 percent of merchandise imports (excluding diamonds, Judea-Samaria and Gaza); imported investment goods accounted for 20 percent, and consumer goods for 15 percent (Table 6.5).

Imported consumer goods rose by 20 percent in 1992, after a similar increase in 1991. Imports of consumer durables rose even faster, by 27 percent, after increasing by 30 percent in 1991 and 28 percent in 1990. Imported intermediates (excluding fuel and diamonds) increased by 15 percent; the greater demand for intermediates in industries where activity was expanding rapidly was notable, an example being the steep rise in cloth and yarn imports.

Since 1990 the increased demand for inputs has been based on the fall in their prices relative to producer prices (prices of factors of production). The cumulative increase in prices of imported intermediates in 1990–92 was 21 percent, while producer prices rose by 45 percent.

After two years of rapid expansion, merchandise imports from North America slowed in 1992, whereas those from Europe and countries with which Israel does not have trade agreements continued to rise for the third successive year. Imports from the latter grew by 17 percent, after increasing by an annual 20 percent in 1990 and 1991. Preliminary data for the last quarter of 1992 indicate that imports from these countries have not yet started accelerating. Import tariffs were reduced in September 1992 (as part of the policy of exposure to imports from third countries, i.e., South East Asia, South America and Eastern Europe—see below), and customs receipts on imports from these countries rose slightly (in the last quarter of 1992 compared to the equivalent period in 1991), apparently because of changes in the composition of imports and the import of previously unavailable goods.

The liberalization of foreign trade

Israel has signed trade agreements with the EC (in 1975) and the US (in 1985); in 1992 an agreement was signed with EFTA (Finland, Norway, Sweden, Austria,

Table 6.5
Merchandise Imports (c.i.f.) by Economic Destination, 1989–92

	$ million				Annual change, percent					
					Price			Quantity		
	1989	1990	1991	1992	1990	1991	1992	1990	1991	1992
Consumer goods	1,329	1,602	1,875	2,308	6.6	–3.2	2.6	13.1	21.0	19.9
of which Durables	560	747	914	1,204	4.2	–5.5	3.7	27.9	29.6	26.9
Investment goods	1,612	2,228	3,046	3,239	7.7	–0.2	2.5	28.3	36.9	3.8
of which										
Machinery and equipment	1,234	1,636	2,126	2,253	8.4	1.3	2.4	22.4	28.2	3.5
Land transport equipment	327	420	689	855						
Total intermediates	10,130	11,318	11,824	13,084	6.7	–6.7	–1.8	4.8	11.9	12.7
Fuel	1,247	1,535	1,474	1,713	22.5	–23.3	–4.8	0.5	25.2	22.1
Diamonds (net)	2,869	2,895	2,558	2,910	13.5	–0.5	5.6	–11.1	–11.2	7.8
Mobile homes		12	208							
Other	6,014	6,876	7,577	8,460	2.0	–4.5	–3.2	12.2	15.4	15.4
Merchandise n.e.s.[a]	–44	–42	–48	–67						
Total net imports	**13,027**	**15,107**	**16,697**	**18,564**	6.8	–5.3	–0.5	8.5	16.7	11.7
Balance-of-payments adjustments	–471	–519	–568	–541						
From Judea-Samaria & Gaza	107	177	190	249	8.8	–2.2	7.5	52.4	9.7	21.9
Total	**12,663**	**14,765**	**16,319**	**18,272**	6.9	–5.2	–0.4	9.1	16.6	12.4
Total excl. fuel, diamonds, and imports from Judea-Samaria & Gaza	8,440	10,157	12,097	13,399	3.7	–3.3	–1.1	16.1	23.2	12.0

[a] Net of returned imports.

SOURCE: Based on Central Bureau of Statistics data.

Iceland, Lichtenstein, and Switzerland). Since September 1991 Israel has pursued a program of gradual exposure to imports from countries with which it has no trade agreement. The object of the liberalization program (i.e., removal of protection from domestic production) is to prevent the inefficient allocation of resources due to non-uniform protection (multiple effective exchange rates).

Table 6.6
Import Taxation, Selected Years, 1980–92[a]

(percent)

	1980	1986	1989	1990	1991	1992
Average tax rate						
Consumer nondurables	20	25	23	22	22	24
Consumer durables	110	96	74	69	67	67
Intermediates	5	7	4	4	4	4
Producer durables						
Machinery and equipment	11	11	10	8	7	8
Motor vehicles	39	83	64	65	54	60
Total imports	9	16	11	11	11	12
Change in average tax rate on total imports, due to						
Tax rates		1.7	–4.0	–0.8	–1.5	–2.5
Composition of imports		5.3	–1.0	0.8	1.5	3.5
Average effective exchange rate of all imports		1.72	2.13	2.24	2.55	3.08
Coefficient of variation of effective exchange rates		0.24	0.20	0.21	0.33	0.45

[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.

The trade agreements have led to the increased relative exposure of the economy to imports; this applies especially to industrial goods, but discrimination still exists with regard to consumer goods since there are purchase taxes which apply mainly to these products. Purchase tax is calculated on wholesale prices, and for imported items a certain percentage is normally added to the prices at the port, intended to reflect the costs incurred in getting them from the importer to the wholesaler. It is reasonable to assume that particularly high rates for certain products protected local production of, for instance, cosmetics (170 percent), carpets (80 percent), small refrigerators and washing machines (70 percent). In addition, until January 1993 there were still certain products, especially in textiles and footwear, on which purchase tax was payable on imported goods, while local production was granted a partial exemption. The 2 percent impost on all imports (the Peace for Galilee levy) will be reduced to 1 percent no later than the beginning of 1995, in accordance with Israel's undertaking to GATT, and surcharges of this kind will be used only during periods of balance-of-payments crises.

The main area in which local products are still protected is imports from third countries. As these countries' share of world trade is growing, and the government would like to divert imports from expensive sources to cheaper ones, it was decided to extend the exposure program to these countries too.

In September 1991, as the first stage of the program, administrative protection through licensing requirements and quotas was replaced by import tariffs. This shift was reflected by increased tax receipts and a reduction in importers' economic rent. The first stage of the liberalization program prepared the ground for the gradual reduction of tariffs and the effective exposure of the economy.

In the first year of the program the level of protection against imports from third countries might have increased, because special tariffs were imposed on certain groups of products (textiles, clothing, footwear, plywood, fertilizers), in addition to the high basic rate of customs (between 20 and 75 percent). These special tariffs raised the effective customs duties to several hundred percent. Import licenses are still required for these products, but are granted automatically, and are used merely for statistical purposes.

The second stage of the program, the start of the gradual reduction of customs duties, came into effect in September 1992. This stage is scheduled to take from five to seven years from September 1991, according to category, with the period for textiles and clothing extended to nine years, until a maximum level of 8–12 percent is reached. In September 1992 the customs duties were reduced by a seventh or a fifth, according to the product's predetermined rate of exposure, and it was decided that for certain products the rate of customs, including the special tariff, would not exceed 110 percent. An exception was made for clothing, with a minimum tax of NIS 6 per unit, even in instances where this raised the effective rate to over 110 percent. Rates will be reduced by a fifth or a seventh each year as the program continues, eventually reaching about 10 percent. For certain groups the rate will be reduced to 75 percent in September 1993 and 60 percent in September 1994, and thereafter by a seventh each year until it reaches 12 percent in 1998. This will enable firms to prepare themselves for exposure to competing imports. Firms which might suffer as a result of the program will also be eligible for benefits to help them rationalize and adapt to the new conditions.

The program's success inevitably depends on the way it is applied. As it is not based on legislation, and government departments can exercise discretion regarding special levies, deviations might occur. The gradual exposure of the textile and clothing industries was recently extended by two years. Although this extension does not seem significant, it is vital to stand up to pressure groups in order to maintain the credibility of the program, encourage the economy to produce under competitive conditions, and prevent the diversion of investment to goods which are profitable thanks only to the protectionist policy. The fact that the liberalization program coincides with a period of increased economic activity due to immigrant absorption enables it to contribute to the efficient channeling of investments consistent with sustainable growth. In the short term, complementary steps can be taken to ensure that exposing the economy to competing imports does not increase unemployment.

Services account

The surplus in the services account (excluding capital, Judea-Samaria and Gaza) rose from some $ 560 million in 1991 to $ 1.3 billion in 1992. The increase in income from tourism was especially notable, as was that from 'other services,' including labor and agents' fees. The export of 'other services' rose by some $ 500 million, similar to the increase in imports of this item. A deficit of $ 200 million in tourist services in 1991 was converted into a surplus of $ 200 million in 1992. Although outgoing tourist expenditure increased by $ 100 million over 1991, tourist income rose by $ 570 million.

Table 6.7
The Exchange Rate, 1985–92[a]

	Average exchange rate[c]	Coefficient of variation[d] (percent)	Midpoint rate[d]	Band[e] (percent)	Interest on SROs[b]	
					Rate[f]	Coefficient of variation[g]
1.7.85–31.7.86	1.49	0.60				
1.8.86–12.1.87	1.49	0.10				
13.1.87–30.10.87	1.68	0.15			1.41	29.7
1.12.87–25.12.88	1.72	0.14			1.00	16.7
3.1.89–22.6.89	1.91	0.67	1.95	±3.0	1.00	19.9
23.6.89–28.2.90	2.07	0.62	2.07	±3.0	0.94	16.7
1.3.90–10.9.90	2.19	2.13	2.19	±5.0	1.03	5.9
11.9.90–10.3.91	2.29	0.20	2.41	±5.0	0.99	2.5
11.3.91–17.12.91	2.53	1.99	2.55	±5.0	1.02	18.3
18.12.91–8.11.92	2.68	2.16	2.63–2.92	±5.0	0.84	9.9
9.11.92–31.12.92	2.92	0.86	2.92–2.95	±5.0	0.73	0.8

[a] The months in which devaluation occurred are omitted.
[b] Self renewing overnight (on-call deposits).
[c] NIS/dollar up to August 1986; thereafter NIS/currency basket.
[d] Up to 18.12.91 around average rate; since the introduction of the sloping band system–around midpoint rate.
[e] The band was announced on 13.1.89.
[f] Average monthly rate.
[g] Series shown from 1987, when the downward trend of the interest rate levelled off.
SOURCE: Bank of Israel.

Compared to the equivalent period in 1990, tourist arrivals fell by some 50 percent in the first half of 1991 due to the Gulf crisis. Recovery began in the second half of the year, however, with activity in this field reverting to its former level. The loss in tourist income in 1991 as a result of the Gulf war is estimated at $ 430 million.

The number of tourist arrivals rose in 1992, from a monthly average of 124,000 (seasonally adjusted) in the second half of 1991 to 149,000 in 1992. This increase is all the more impressive compared with 1987, a record year for tourism (when the number of tourist arrivals reached 121,000 a month) and the number of tourist bed-nights was higher than in 1992 (694,000 a month compared to 630,000).

A comparison of tourism by country of origin with the record year of 1987 shows that tourist arrivals in 1992 went up by 280,000 (about 18 percent); there was a particularly notable increase in tourism from the United Kingdom (by 104,000, from 12 to 16 percent of all arrivals), while tourism from the US rose by some 49,000 (holding steady at about 21 percent of the total), and that from the former USSR went up by 47,000 (from zero to 2.6 percent). Most of the increase from the UK was in cruise-passengers, who stay for a short time, and contribute little to hotel income.

Unilateral transfers

In 1992 unilateral transfers rose by $ 200 million, to $ 6.9 billion. In 1991, the year of the Gulf war, Israel received special aid amounting to $ 800 million. However, the US government split the civilian aid into two payments, as a non-recurring arrangement. Consequently, Israel received half of the 1991 civilian aid, amounting to $ 600 million, in 1992, in addition to the full 1992 aid of $ 1.2 billion.

Private-sector transfers rose by $ 530 million in 1992, partly due to cash transfers by new immigrants; in recent years these transfers have not matched the rate of arriyal of new immigrants.

3. THE CAPITAL ACCOUNT AND THE EXTERNAL DEBT

Private capital exports in 1992 totalled $ 2.1 billion; this was especially notable in the last quarter of the year, when the private sector purchased foreign currency from the Bank of Israel amounting to about $ 1.2 billion above its current-account deficit.

The explanation of the private sector capital export lies in the cumulative effect of the process of liberalizing foreign exchange and capital movements, which enabled banks' foreign-currency deposits to be transferred from the Bank of Israel to banks abroad, and the public's portfolio to be adjusted to various foreign-currency assets, and foreign securities in particular. In the second half of the year the expected profitability of foreign assets purchases rose.

The economy is expected to benefit greatly from the continuation of the liberalization process: reduced control of capital movements allows access to foreign assets and foreign-currency credit, thus exposing the economy to world capital prices, and limiting distortion in resource allocation. Liberalization also diverts capital back into official channels, and increases competition in the financial markets. On the other hand, the closer contact between the domestic and foreign financial markets to some extent reduces the effectiveness of domestic monetary policy .

Private-sector capital movements

Exchange-rate policy plays a central role in maintaining price stability, acting directly as an anchor for prices via its influence on prices of tradables, which are determined according to the exchange rate (and prices abroad), and via its effect on expectations. Prices of nontradables are determined in relation to those of tradables, thus the real exchange rate (the relative price) is determined through the equilibrium of demand and supply factors. For instance, an increase in demand for nontradables, and technological advances in the production of tradables, will be reflected by real appreciation. However, an economy in which price rigidities exist, e.g., in the process of forming expectations and signing contracts in nominal terms, is liable to deviate from the real equilibrium exchange-rate in the short run. In the past, in order to reduce the effect of nominal rigidities on the real exchange-rate, the rate was raised from time to time, so that real

Table 6.8
Balance of Payments, by Sector, 1988–92[a]

($ million)[b]

	1988	1989	1990	1991	1992
Public sector					
Current account	690	1,033	1,641	1,652	1,877
Medium- and long-term capital movements[c]	–672	65	–62	646	694
Basic account	18	1,098	1,579	2,298	2,572
Short-term direct capital movements	39	–119	–47	0	–4
Capital movements via banking system	590	–554	149	196	–27
Errors and omissions	539	256	–614	–375	–74
Effect on foreign reserves[d]	–1,186	–681	–1,067	–2,118	–2,467
Private sector					
Current account	–247	25	–1,236	–2,176	–1,723
Medium-and long-term capital movements[c]	130	58	38	–621	–1,344
Basic account	–117	83	–1,198	–2,797	–3,067
Short–term capital movements	–230	–294	–234	–53	–599
Capital movements via banking system	–1,106	–113	–376	–566	–1,556
Errors and omissions	–902	1,042	1,255	1,258	1,420
Effect on foreign reserves[d]	2,356	–717	552	2,157	3,802
Implied private capital imports[e]	–2,109	692	684	19	–2,079

[a] Figures may not add due to rounding.
[b] At current prices.
[c] Redemption of the Arrangement bank shares held by foreign residents was deducted from the private sector's capital movements and added to those of the public sector.
[d] Increase (-), decrease (+).
[e] Defined as the difference between the private sector's purchases of foreign exchange and its current account.

SOURCE: Based on Central Bureau of Statistics data.

forces could express themselves fully and more quickly in determining the prices of tradables relative to nontradables, though this involved making some concessions when it came to slowing inflation.

These discrete changes in the exchange rate gave rise to speculative foreign-currency purchases around the expected time of the change. In 1988, for example, there was a particularly large surge (see below).

Since January 1989 the exchange-rate policy has allowed the rate against the currency basket to move within a band around a midpoint. Until December 1991, the midpoint rate was raised approximately twice a year. When the rate was raised in March 1991, representing an effective 6 percent increase in the exchange rate, the credibility of the system was called into question, as this step signalled that the movement of the rate within the band did not preclude discrete devaluations. In order to avoid large-scale speculative currency purchases around the time the midpoint rate was realigned, it was announced in December 1991 that this rate would be continuously adjusted on a daily basis along a preset (sloping) path. In November 1992 the rates were changed—the midpoint rate was raised by 3 percent, and its annual rate of adjustment was reduced from 9 to 8 percent.

The changeover from a horizontal to a sloping band in December 1991 reduced the probability of speculative capital movements, while increasing certainty regarding the annual rate of devaluation—something which is vital in the context of Israel's trade ties.

With the continued move to financial deregulation in 1992, the effect of the sloping band system on demand for foreign currency should be examined in the light of the relation between foreign-exchange and monetary policies. The object of monetary policy in 1992 was to expand economic activity. The rate of devaluation, the reduction in the domestic interest rate, and the relatively low rate at which foreign interest rates fell compared to domestic rates (Table 6.9), reduced the relative yield on domestic assets, encouraging the repayment of foreign-currency loans and the purchase of foreign assets, thereby contributing to the export of capital in the second half of the year . On the other hand, the system of midpoint-rate adjustment along a predetermined path (the sloping band) increased certainty as to the expected yield on foreign assets by guaranteeing a minimum rate of return on them. This greater certainty, against the background of the monetary policy and liberalization, pushed up demand for foreign currency, thus illustrating the limited effectiveness of monetary policy.

Following private-sector capital imports in the first quarter of 1992, there were two upswings in demand for foreign currency in the second half of the year, one during the period of the general election and extension of liberalization (June/July), and the other after the November adjustment of the midpoint exchange rate. Two factors accounted for the rise in demand. First, by adding investment possibilities abroad to those which had opened up in recent years, the continued liberalization of foreign exchange enabled the public to extend its portfolio. Second, the high unemployment rate—about 11 percent—led policy-makers to avoid increasing domestic interest rates in an effort to stimulate economic activity and increase employment.

Thus, the pace of devaluation was stepped up somewhat during 1992, from an annual 11 percent in 1990–91, to 15 percent in 1992. From the beginning of the year to November, devaluation against the currency basket was 9.5 percent, similar to the annual rate of recent years, but towards the end of the year the effective rate of devaluation was increased, in order to slow down the sale of reserves and prevent interest rates rising. This involved no change in the exchange-rate policy, and came in response to demand for foreign exchange arising from lower domestic interest rates (see Chapter 7). As the increased demand for foreign currency occurred near the middle of the year, the annual average rate of devaluation against the currency basket did not accelerate, and in effect there was even a small decline. Due to the interest-rate policy and devaluation, the greater demand for foreign currency by the private sector was reflected mainly by the $3.8 billion reduction in the foreign reserves, compared to the $2.2 billion reduction of 1991.

The liberalization of foreign exchange

The gradual liberalization of foreign exchange and capital movements, which started in 1987, continued in 1992, the object being to strengthen the financial ties between

Table 6.9
Capital Imports and the Gap Between Domestic and World Interest Rates, 1991–92

	1991				1992			
	I	II	III	IV	I	II	III	IV
Implied private sector capital imports ($ million)	916	71	–154	–814	193	–491	–544	–1237
Interest Rates								
Average rate on discount-window loan	13.2	12.4	13.3	18.1	12.3	11.0	11.0	10.5
Overdraft facilities[a]	28.7	28.2	28.2	34.7	26.1	21.2	21.2	19.4
SROs[a,b]	12.0	11.3	11.8	16.6	11.7	10.0	10.1	9.4
3-month Eurodollar rate[a]	13.4	11.6	10.1	6.4	8.2	12.0	7.8	12.7
Interest-rate gap[c]								
Discount-window loan	–0.2	0.9	3.2	11.7	4.1	–1.0	3.2	–2.1
Overdraft facilities	15.3	16.6	18.1	28.3	17.9	9.2	13.4	6.7
SROs	–1.4	–0.3	1.7	10.2	3.5	–2.0	2.3	–3.3

[a] Annualized rate.
[b] Self-renewing overnight (on-call deposits).
[c] The difference between each domestic rate and the 3-month Eurodollar rate.
SOURCE: Central Bureau of Statistics and Bank of Israel.

markets in Israel and abroad, and thereby aid more efficient resource-allocation. In 1992 this was reflected in a further significant increase in Israelis' investments abroad, and greater international mobility of banks' foreign-currency deposits. Banks' deposits abroad rose in 1992, and the liquidity requirement was reduced to help meet the objective of improved resource-allocation, and increase the yield on deposits.

In 1992 most of the public's foreign investments were via mutual funds, which had been permitted to trade in foreign securities since May 1989, but whose activity in this field had been delayed because of the need for new taxation and supervisory regulations. The tax regulations were gradually completed and simplified, and the number of authorized funds was increased. In mid-1992 the method of calculating tax on mutual funds was altered, and it was announced that the new method would apply to all funds from the beginning of 1993. Mutual funds wishing to specialize in foreign investment are still limited with regard to the composition of their portfolios, at least half of which must comprise securities issued in Israel.

As part of the gradual liberalization of foreign exchange, residents were permitted to purchase recognized foreign securities, and not only foreign securities issued abroad by Israeli companies, as had formerly been the case. This applied to shares, bonds, and options in a number of recognized stock exchanges. Another stage in the liberalization process expanded the public's ability to adjust its portfolio, although this was limited by the complexity of taxation.

Residents' investments abroad totalled about $2.7 billion in 1992 ($1.5 billion and $350 million in 1991 and 1990 respectively). This rise partly reflects the public's adjustment of its portfolio towards foreign-currency assets. As a result, net investments abroad increased from $150 million in 1990 to $760 million in 1991, and to $1.4 billion in 1992.

Israeli firms' opportunities of investing abroad directly were also extended. In November 1991 the permitted level of direct investment abroad was raised from 20 to 40 percent of the investing company's equity. The increase in investment opportunities resulting from the relaxation of control was expressed mainly in the larger number of individual permits based on the capital criterion which were issued in 1992, but there has not yet been any real rise in investment. In December 1992, companies more than 75 percent of whose shares are held by nonresidents were granted individual permits to extend credit to their owners of up to 40 percent of their equity, and subsidiary companies were thus enabled to finance foreign activities of their parent companies.

In January 1992 certain restrictions were removed from transactions in Israeli securities by nonresidents, who were permitted to reconvert income from Israeli securities, including that from investments via Israeli mutual funds. This led to some substitution of investment via mutual funds for investment in foreign equities. However, total net investment in Israel by nonresidents remained stable in 1992.

As part of the reform of the money and capital markets, the liquidity ratio requirement on residents' foreign-currency deposits (resident restitution deposits) was reduced. This, together with the greater freedom granted to the banks in directing their foreign-exchange investments abroad and the increase in nonresidents' deposits, caused the external use of banking resources to rise by $ 1.6 billion, while internal use fell by $ 1.3 billion. The liberalization of banking supervision was thus reflected in a $ 1 billion decrease in the banks' liquid deposits with the Bank of Israel, a $ 400 million increase in foreign securities, and a $ 1 billion increase in bank deposits abroad. The reduced liquidity requirement for banks' deposits with the Bank of Israel resulted, inter alia, in a fall in the Bank of Israel's reserves.

Table 6.10
Assets and Liabilities in Foreign Currency, 1988–92[a]

($ million)

	1988	1989	1990	1991	1992
Gross liabilities[b]	**31,522**	**31,476**	**32,781**	**33,206**	**33,631**
Banking system assets	6,775	7,428	8,317	8,897	10,665
Total liabilities[b]	**24,746**	**24,048**	**24,464**	**24,309**	**22,967**
of which Government	16,519	16,511	16,641	17,247	18,058
Nonfinancial private sector	4,299	4,304	4,611	4,305	3,814
Banking system, net	3,928	3,232	3,212	2,757	1,095
Foreign reserves	**4,311**	**5,649**	**6,451**	**6,442**	**5,299**
Exporters' credit to foreigners	**1,854**	**2,091**	**2,350**	**2,346**	**2,561**
Net liabilities[b]	**18,581**	**16,308**	**15,663**	**15,521**	**15,107**
Current debt					
Banking system (short term)	1,138	1,204	2,573	2,728	1,256
Nonfinancial private sector (short term)	1,401	1,418	1,554	1,393	1,074
Direct government debt (short term)	101	0	0	0	0
Medium and long-term debt repayable within a year	1,572	1,894	1,806	1,850	1,785
Total current debt	**4,211**	**4,516**	**5,933**	**5,971**	**4,115**
Net current debt[c]	**–1,954**	**–3,224**	**–2,868**	**–2,817**	**–3,745**

[a] Differences in totals are 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.

[c] Total current debt *less* foreign reserves and exporters' credit to foreign customers.

SOURCE: Based on Central Bureau of Statistics data.

At the beginning of July 1992 the freedom to manage unrestricted deposits, which had hitherto applied only to the business sector, was extended, and any resident could deposit recognized foreign-currency receipts with the banks. Withdrawals from foreign-currency deposits may still be made only for approved transactions.

Thus, in 1992 the cumulative effects of the liberalization of foreign exchange and its continued gradual pace were expressed more forcefully in capital movements. This applied once economic conditions had increased the profitability of holding foreign currency. These conditions emphasize the need to implement the liberalization program in a gradual and controlled manner, and the vital importance of creating stable macroeconomic conditions, especially in the capital market, as the process continues.

The external debt and reserves

Israel's net external debt fell in 1992 by some $400 million, to $15.1 billion. Taking into account the increase in GNP and the relative stability of the average real NIS/dollar exchange rate, the net debt/GNP ratio fell from 27 percent in 1991 to 24 percent in 1992. This decline has persisted since the ESP was introduced in 1985, when the debt/GNP ratio was as high as 78 percent (Figure 6.3).

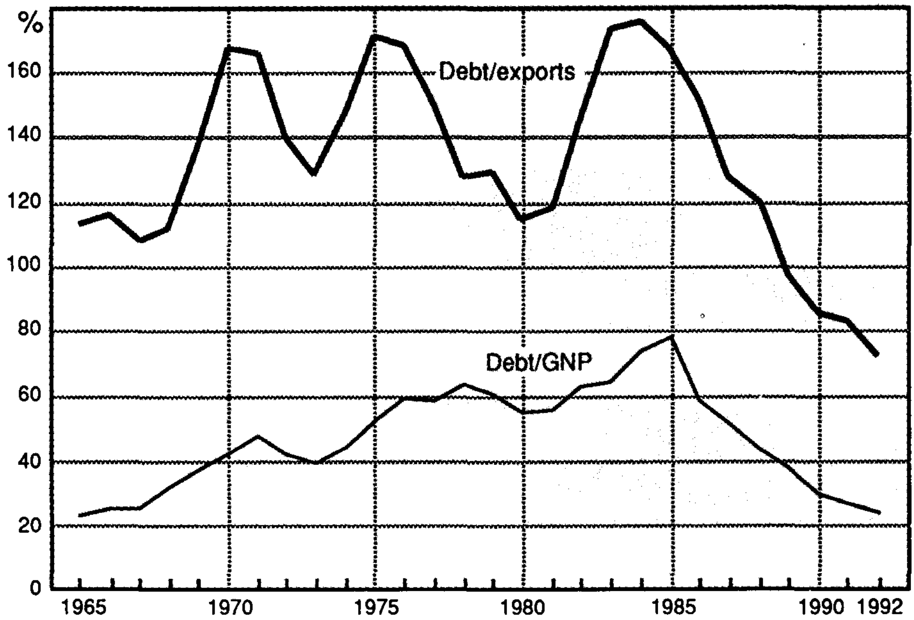
Table 6.11
The External Debt Burden, 1987–92[a,b]

	1987	1988	1989	1990	1991	1992
$ million						
Interest payments on net external debt	2,286	2,506	2,502	2,608	2,399	2,304
Interest receipts on foreign-currency assets	811	968	1,235	1,587	1,615	1,405
Net interest payments on net external debt	1,474	1,538	1,267	1,021	784	899
Other capital services						
Debit	152	129	159	168	139	201
Credit	35	32	34	18	45	–14
Repayment of principal	1,636	6,617	2,295	2,131	2,206	1,850
Total net debt servicing	**3,228**	**3,473**	**2,964**	**3,302**	**2,684**	**2,965**
Percent						
Net interest/net external debt[c]						
Nominal	8	9	7	6	5	6
Real[d]	6	5	3	4	3	4
Interest/income at disposal of economy[e]	4	3	3	2	1	1
Net interest/exports [f]	11	11	8	6	5	5
Net debt servicing/exports [f]	25	24	19	19	16	15
Net debt servicing/(exports[f] + transfers[g])	18	18	14	15	11	11
Net debt servicing/GNP	9	8	7	6	5	5

[a] Figures may not add due to rounding.
[b] Net debt servicing figures for 1988–92 are net of conversion of the debt to the US government.
[c] The denominator is the debt lagged six months.
[d] The nominal figure (preceding line) deflated by the rate of inflation in industrialized countries (5-year average), as an indicator of long-run inflationary expectations.
[e] GNP (in dollars) + net unilateral transfers.
[f] Exports f.o.b. excluding capital services.
[g] Net unilateral transfers.
SOURCE: Based on Central Bureau of Statistics data.

The net debt/exports ratio fell from 84 percent in 1991 to 73 percent in 1992. Its decline is adjusted for the direct effects of exchange-rate changes, and expresses the impressive achievement in export growth, as well as the change in the debt.

Figure 6.3
Ratio of External Debt to Exports and GNP, 1965–92



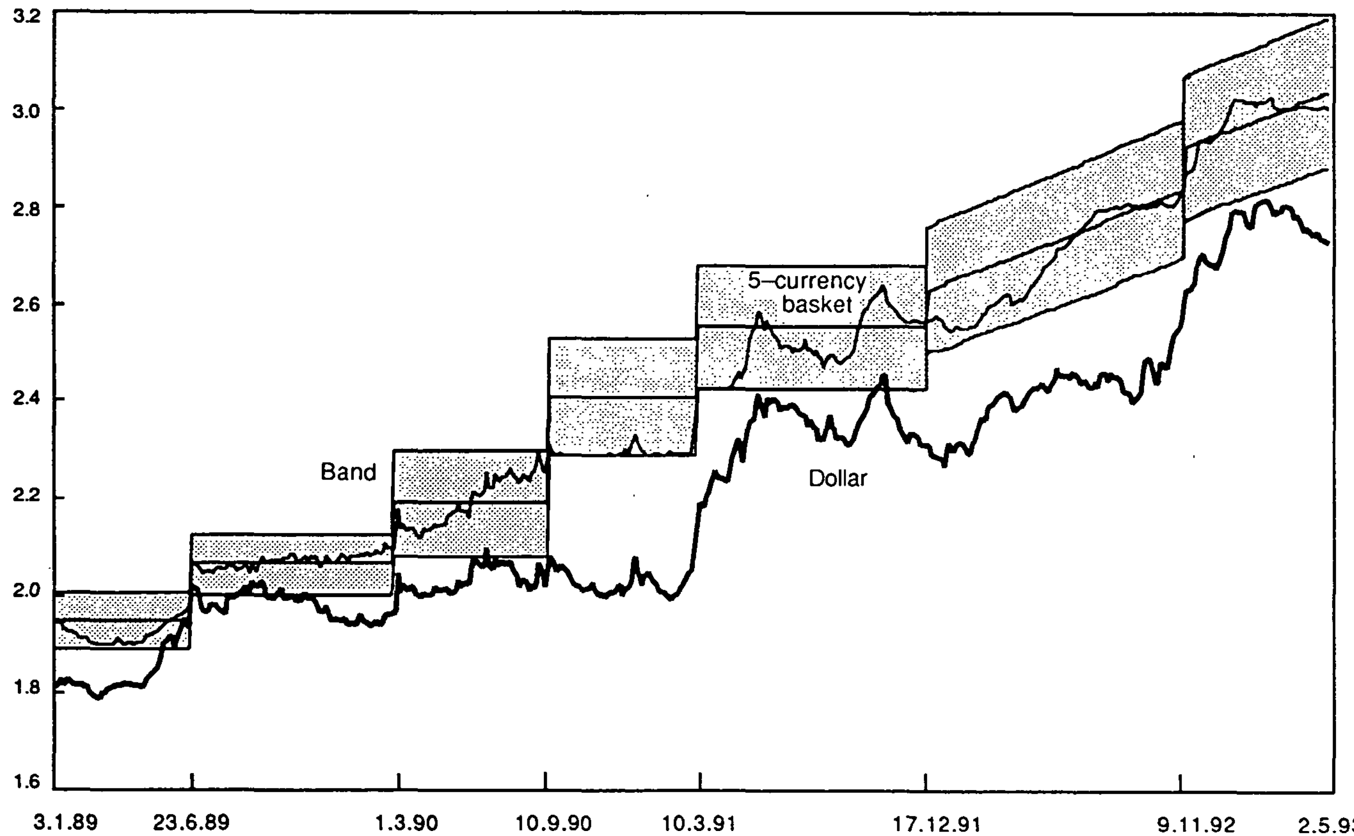
SOURCE: Based on Central Bureau of Statistics data.

The current debt, which provides an estimate of the significance of restructuring the debt, fell by $ 1.9 billion in 1992 from 1991. This reflects mainly a $ 1.5 billion reduction of the banking system's short-term debt (Table 6.10), most of it resulting from transfers overseas of banks' deposits with the Bank of Israel. The expected repayment of long- and medium-term debts in 1993 has fallen by about $ 100 million.

Banks' net overseas liabilities reflect the gap between their external sources and applications. About 90 percent of the external sources consist of foreign residents' deposits, which rose by 4.8 percent in 1992. Total external sources rose by about $ 90 million in 1992. Banks' external applications rose by about $ 1.6 billion, largely as a result of the liberalization program. The transfer of banking assets from internal to external applications led to the reduction of the banks' net debt by some $ 1.5 billion in 1992.

The sources of debt in the economy can be gauged by total liabilities, i.e., the difference between the gross external debt and the commercial banks' foreign-asset hold-

Figure 6.4
The Sheqel Exchange Rate Against the Currency Basket and the Dollar, 1989–92 [a]



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

ings. Some 80 percent of total liabilities are government debts, 84 percent of which derive from three sources—direct debts to the US government (21 percent), debts converted into fully-guaranteed bonds tradable on the US capital market (29 percent), and State of Israel Bonds and certificates (34 percent).

Table 6.12
Average Interest Rates on New Dollar Loans, 1987–92

(percent p.a.)

	1987	1988	1989	1990	1991	1992
Government						
Medium term	8.0	9.1	9.6	9.2	7.8	5.8
Long term	7.0	9.3	8.7	8.1	7.0	7.0
Private sector						
Short term	8.2	8.9	10.3	8.9	6.8	4.9
Medium term	8.3	9.0	10.1	9.1	7.3	5.3
Long term	8.2	8.7	9.2	7.0	6.6	4.8

SOURCE: Bank of Israel, Controller of Foreign Exchange.

The decline in the net external debt consists of the $ 700 million reduction in the debt of the nonfinancial private sector, the $ 1.7 billion contraction of the banking system's debt, and the $ 2 billion increase in the government debt. The increase in the external debt and the decline in the commercial banks' debt reflect mainly the transfer of deposits from the Bank of Israel to overseas deposits.

The decline in dollar interest rates reflects their continued fall internationally. Interest on long-term credit to the private sector fell by more than that to the public sector, while for medium-term credit both fell at a similar rate. The lower rate of interest on medium- and long-term loans to the private sector is due to the difference in the term of the loan, public-sector borrowing being longer-term than that of the private sector. The reduction in interest rates on credit to Israel was similar to that in world rates, presumably reflecting Israel's standing as an international borrower.

The foreign reserves remained relatively stable during the first half of 1992, whereas in the second half there was a drop of $ 1.4 billion, from $ 6.7 billion to $ 5.3 billion. This represented a reduction from a level equivalent to approximately 3.2 import months in the first half-year, the customary international level, to 2.6 import months in the final quarter. Note, however, that the increase in imports which was concurrent with the expansion of exports, does not necessitate a fixed ratio of reserves to import months, especially in view of the expected loan guarantees.

Towards the end of 1992 the US government's loan guarantees to Israel for immigrant absorption were approved, totalling $ 10 billion—$ 2 billion per annum for five years. Of the first $ 2 billion, one third will be used to finance government investments, one third will be transferred to the private sector via the banking system, and one third will serve as a reserve for financing the future expansion of investment and preparing for the

Table 6.13
The Banking System: Foreign Currency Sources and Applications, 1991–92

($ million)

	December 1991	December 1992		December 1991	December 1992
Deposits from foreign banks	1,579	1,201	Cash and deposits in foreign banks	6,704	7,770
Nonresidents deposits	9,960	10,437	Credit to nonresidents	825	924
Bonds	85	76	Investment in foreign securities	1,367	1,761
Total external sources	**11,624**	**11,714**	**Total external applications**	**8,896**	**10,455**

SOURCE: Bank of Israel, Controller of Foreign Exchange.

possible renewal of mass immigration. This division of the monies covered by the guarantees is intended to ensure that they are used for investment, mainly in the tradables sector, enabling the rapid and sustainable growth of output and preventing future debt-repayment difficulties.