Developments in the Economy's Basic Account over the Past Two Decades

Hadar Gotsman* and Shelly Reiss*

Abstract

The basic account is an accepted aggregate for analyzing data about the economy's balance of payments. There are various definitions for the basic account, but according to the generally accepted definition it includes the current account surplus and net direct foreign investment (incoming investment minus outgoing investment). This paper presents data on the basic account in Israel according to its various definitions, and describes the developments and fluctuations in the basic account and its components over the past two decades.

According to the generally accepted definition, the basic account in Israel went, in 2004, from balance to surplus—a surplus that was maintained continuously through 2014. This switchover to surplus was linked to many structural changes that took place in the economy, headed by the consolidation of the high tech industry, which contributed to both the creation of a current account surplus and a significant increase in the flow of direct investments. The ongoing surplus in the basic account reflects the importing of structural capital into the economy. Looking ahead, the discovery of the natural gas reservoirs and the production of natural gas for both domestic needs and exports constitute a significant factor that will support the persistence of a basic account surplus.

* The Information and Statistics Department, Bank of Israel

A. Introduction

The balance of payments in the economy measures all the transactions between residents of Israel and nonresidents in foreign currency and in shekels. Transactions are usually classified in the balance of payments according to their type. For example, transactions involving imports and exports of goods and services are included in the current account, and transactions involving imports and exports of capital are included in the financial account. Within the financial account, a distinction is usually made between direct investments (investments by parties at interest in companies) and financial investments in marketable securities and other investments (deposits and credit).

In an analysis of the balance of payments data, among other things, consideration is given to an aggregate called the "basic account," which includes the current account surplus and net foreign direct investment (FDI). The basic account makes it possible to identify the structural changes occurring in the economy over the years, and which are reflected in the balance of payments. Its components—direct investments and the current account—are more affected by long-term changes in the economy's fundamental data, such as growth and competitiveness of the economy vis-à-vis abroad, and are less sensitive to short-term changes in economic parameters such as interest rate spreads, exchange rates, and share indices. These short-term changes have more effect on the other items in the balance of payments, such as financial investments and other investments.

The "structural" effect of the balance of payments on the foreign exchange market—the effect resulting from the fundamental factors in the economy—can also be derived from the basic account, i.e., the basic account can be used to determine whether there is a structural surplus in demand for foreign currency or a structural surplus in the supply of foreign currency. The surplus/deficit in the basic account reflects the direction and power of the surplus structural supply of/demand for foreign currency (the "basic pressure") on the exchange rate.

The effect of the basic account aggregate on the exchange rate trend is also discussed in various international publications. For example, a 2011 article of the International Monetary Fund[1] examined the effect of the basic account, according to two different definitions, on the changes in the exchange rate of the euro and the Japanese yen against the dollar.

In the literature and in accepted practice, the definition of long-term capital flows to and from an economy is not always unambiguous, and is likely to differ from one economy to another, and sometimes even from one period to another.

Some of the definitions are broader, and also include long-term financial investments (providing that these can be measured). Other definitions are narrower, and bring into the aggregate only FDI inflows.

[1] Robin Brooks, Hali Edison, Manmohan Kumar, and Torsten Slok, 2001, "Exchange Rates and Capital Flows," IMF Working Paper, WP/01/90.

In this paper, the aggregate of the basic account—according to the various definitions—in Israel will be viewed, and the currently accepted definition—the current account surplus and net foreign direct investments in the economy—will be adopted, in order to describe the developments and fluctuations in the economy's basic account and its components over the past two decades (1998-2014). In addition, the basic account in Israel will be compared to the basic account in OECD countries, and in a group of developing economies.

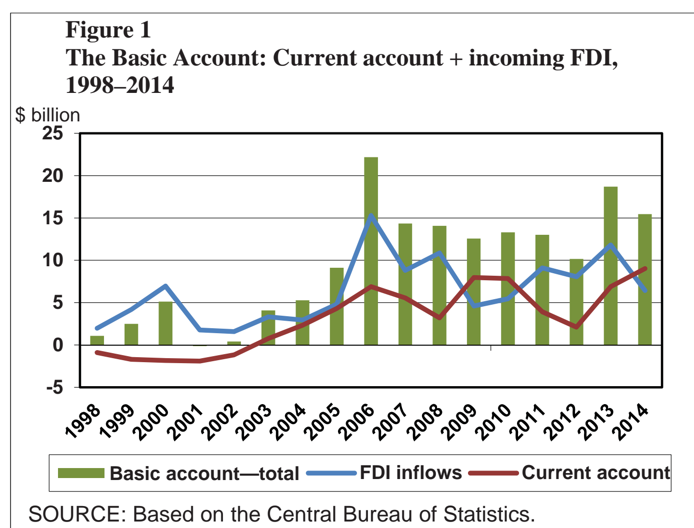
B. The Basic Account in Israel

1. Various Definitions of the Basic Account in Israel

Three different definitions of the basic account can be applied in Israel:

The restrictive definition of the basic account (Figure 1) adds to the current account surplus only the direct investment entering the economy (FDI). In a definition like this one, the basic account reflects **gross** imports of long-term capital into the economy, but does not take into account exports of structural capital from the economy, such as the economy's direct investments abroad. In this definition, the basic account surplus has maintained a high annual level over the past decade (2005–14), averaging $14.3 billion a year.

Figure 1
The Basic Account: Current account + incoming FDI, 1998–2014



SOURCE: Based on the Central Bureau of Statistics.

A more inclusive definition (Figure 2) includes in the aggregate both direct investments abroad by the economy and financial investments abroad by institutional investors, who have invested abroad, since tax discrimination was eliminated in 2004, as part of a long-term risk dispersal strategy. This definition does not include financial investments of any kind in the economy by nonresidents. According to this definition, the basic account surplus is of course reduced, and even becomes negative in some years. Its average over the past decade was only $4.4 billion. At the same time, it is interesting to see with that even by this definition, the basic account surplus has grown significantly over the past three years, mainly as a result of a significant rise in the current account surplus—in 2012–14, the annual basic account surplus averaged $7.3 billion.

Henceforth in this paper, we have chosen to adopt an intermediate definition of the basic account (Figure 3), the most accepted, which adds the net foreign direct investments in the economy to the current account surplus. This definition takes into account only net imports of long-term capital resulting from direct investments in both directions. It does not include the financial investments abroad by institutional investors (or financial investments in the economy by foreign investors).

This definition adopts the distinction in the financial account between the two types of investments—direct and financial. It is based on the volume of exports of financial capital by institutional investors being affected by relatively short-term changes in share prices on overseas markets, and by changes in exchange rates and interest rates. In this definition, the basic account surplus over the past decade averaged $7.8 billion per year.

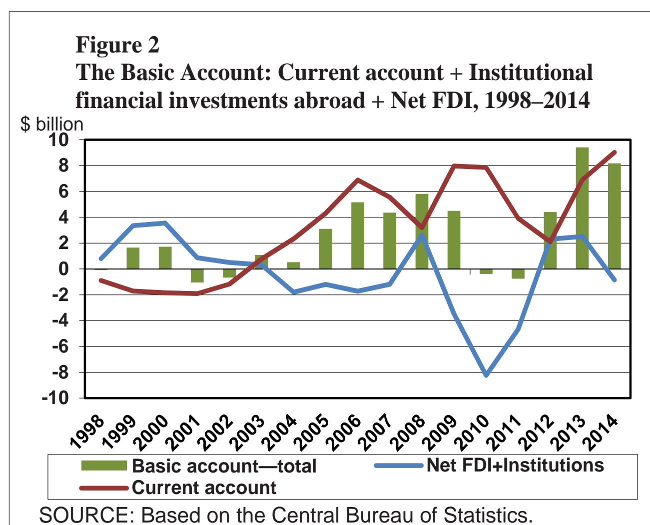


Figure 2
The Basic Account: Current account + Institutional financial investments abroad + Net FDI, 1998–2014

SOURCE: Based on the Central Bureau of Statistics.

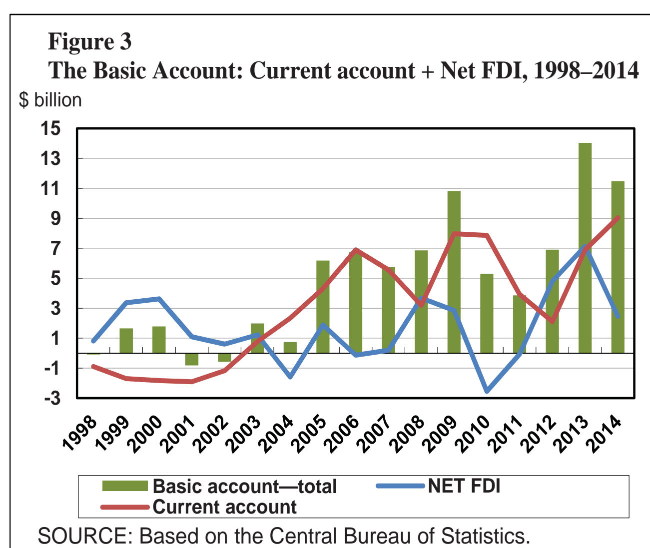


Figure 3
The Basic Account: Current account + Net FDI, 1998–2014

SOURCE: Based on the Central Bureau of Statistics.

2. Two Periods:

Two main periods can be distinguished in the economy's basic account during the period under review (1998–2014, Figure 3):

The period of 1998–2004 featured a current account deficit and a low volume of net direct investment. The basic account surplus was accordingly negligible, and was even negative in some of these years. In contrast, in each of the last 10 years (**2005–14**), there was a substantial basic account surplus (about $7.8 billion per year, 3.5 percent of average annual GDP): a combination of a current account surplus and a positive flow of net direct investment into the economy.

The transition from a relative balance in the basic account during the first period to surplus in the second period is linked to a series of significant processes that took place in the economy and the global economic environment:

In the economy, Israeli industry underwent structural change that led to the emergence of the economy's relative advantages in high tech. A liberalization process in foreign currency and the financial account was completed, and there were geopolitical changes as well. These developments contributed to a marked improvement in the economy's fundamental data and its attractiveness vis-à-vis abroad.

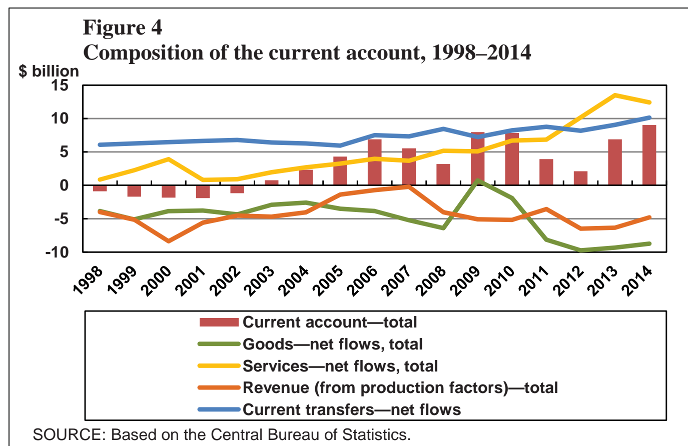
In the world, financial and nonfinancial capital movements to emerging economies increased in the framework of an ongoing globalization process, combined with an expansion in world trade. The combined result of all these factors was increased capital movements to and from the economy. The developments in the energy sector in recent years—the discovery of natural gas reservoirs and the decline in fuel prices—led to further growth in the current account surplus. These are expected to have an even more significant effect on the current account in the coming years.

3. The Components of the Basic Account:

The current account: Until 2002, there was a current account deficit, which reflected a structural surplus of imports over exports in the goods account, net payments to factors of production, and a balanced services account. The ratio of the deficit to GDP increased during this period, reaching -1.5 percent in 2001, following the deflating of the high tech bubble.

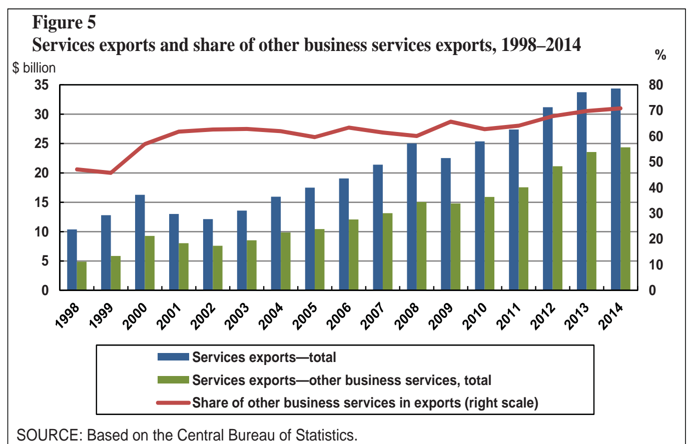
Starting in 2003, the current account went into surplus, which then grew (not continuously), reaching a peak in 2014 (Figure 4). The transition to surplus occurred following a structural change in the economy's export industries and the emergence of the relative advantages of Israel companies in high tech (the proportion of total exports accounted for by the high tech sectors greatly increased). These developments, combined with growth in world trade, contributed to a reduction in the deficit in the goods account and to a substantial

Figure 4
Composition of the current account, 1998–2014



SOURCE: Based on the Central Bureau of Statistics.

Figure 5
Services exports and share of other business services exports, 1998–2014



SOURCE: Based on the Central Bureau of Statistics.

increase in services exports—business services exports (including software exports) constituted 47 percent of all exports of services in 1998, a proportion that increased to 70 percent by 2012 (Figure 5). Furthermore, in some of the years, the deficit in the income from production factors account declined markedly, mainly as a result of growth in income from direct and other investments and a decline in the payment of wages to foreign workers.
There has been further improvement in the current account in the past two years, stemming from the fall in global fuel prices and the discovery of the natural gas reserves in Israel. These developments have reduced the need for fuel imports, and in the coming years will also contribute to an increase in export proceeds resulting from exports of natural gas.

Direct investments: In an overview, up until 2005, gross flows of direct investments to and from the economy were at a relatively low level (except for the bubble year of 2000), and greatly increased in both directions from 2006 until 2014. Net flows of direct investment to the economy were positive during most of these years, with large fluctuations in their proportion of GDP.
At the end of the 1990s, development of the high tech sector in Israel made Israel much more attractive to investors. Direct investments by global companies in Israel in this period reached a peak in 2000 (about 5.3 percent of GDP), and continued until the high tech bubble deflated in 2001. Afterwards, given the economy's negligible growth, accompanied as well by a marked decline in global growth, the volume of direct investments in both directions fell steeply in 2001–02. Beginning in 2003, there was a recovery in the volume of direct investments in Israel, and since 2006, following the significant investment by Berkshire Hathaway in Israeli company Iscar, the flow of direct investment into the economy rose steeply to an annual average of $8.9 billion, compared with a flow of outgoing investment averaging $6.9 billion a year. The global crisis that began in 2008 caused only a temporary dip in investments in both directions in 2009, after which the **net** flow of investments into the economy grew.
Direct investments primarily feature deals of substantial size that are the culmination of long term processes. The investors are parties at interest in companies and retain their holdings for extended periods, and are not inclined to react quickly to short-term fluctuations in the share indices, interest rate spreads, or changes in exchange rates. In contrast, direct investments certainly do respond to significant changes in the business cycles and in domestic and global growth (Figure 6). In periods of decline in growth or global recession—for example, in 2001–02 following the deflating of the high tech bubble, and in 2008–09 during the financial crisis—the flow of direct investments in both directions wanes. The global companies experience liquidity difficulties that restrict their ability to invest, accompanied by tougher management of investments and a decline in their appetite for risk.

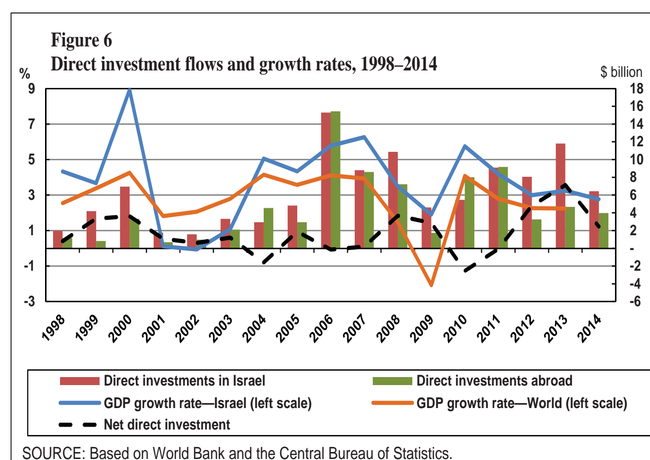


Figure 6
Direct investment flows and growth rates, 1998–2014
SOURCE: Based on World Bank and the Central Bureau of Statistics.

C. The Basic Account in an International Comparison

Basic account data for Israel were compared with two groups of countries: advanced economies, represented by OECD member countries, and developing countries.[2] From an international comparison of the ratio of the basic account surplus to an economy's GDP (Figure 7), it can be seen that over the years, Israel's basic account surplus has been similar to, and slightly lower than, that of the developing countries. At the same time, since 2012, the trend in Israel's basic account surplus, which amounted to 3.8 percent of GDP in 2014, has clearly been positive, compared with a downtrend in the developing countries (about 2.5 percent of GDP in 2013). Over the years, OECD countries have had an average basic account deficit amounting to approximately 1.5 percent of GDP. When the components of the basic account are compared to those of the two comparison groups, the following patterns stand out:

Over the years, Israel's **current account surplus** of about 1 percent is similar to, and highly correlated with, the group of developing countries.[3] At the same time, in the past two years, the trend of this ratio in Israel has been positive, reaching about 3 percent of GDP, contrasting with a downtrend in the average of the developing countries, reaching about 1.4 percent of GDP in 2013. A current account deficit has prevailed in the OECD countries since 2009, amounting to an average of about 0.4 percent of GDP – an improvement, in comparison with the years preceding the financial crisis, when the average current account deficit was about 1.3 percent of GDP (Figure 8).

In recent years, the ratio of FDI inflows to GDP in Israel has been similar to, and correlated with, the group of developing countries (an average of 3.2 percent, excluding 2006, an exceptional year[4]), and slightly higher than the average in the OECD countries, which has been about 1.9 percent in recent years (Figure 9).

The ratio of FDI outflows to GDP in Israel was similar to the ratio in both of the comparison groups (an average of about 2.1 percent, excluding 2006, Figure 10).

[2] Sources of data and calculations: Based on OECD and the UN.

[3] In accordance with the UN definition.

[4] There was exceptional growth in direct investment in both directions in 2006, primarily as a result of two large-scale transactions (the investment of a foreign company in Iscar, an Israeli company, and an investment by Teva Pharmaceutical Industries, another Israeli company, in a foreign company).

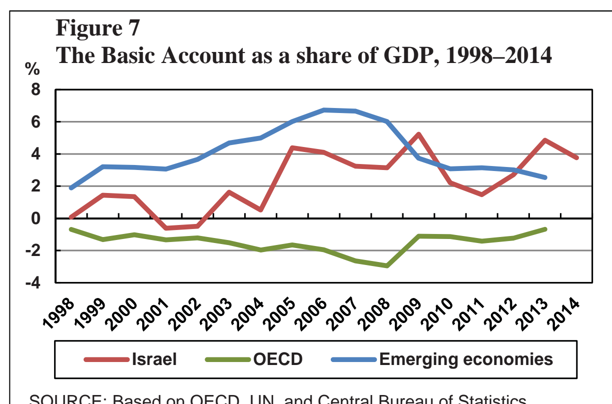


Figure 7
The Basic Account as a share of GDP, 1998–2014

SOURCE: Based on OECD, UN, and Central Bureau of Statistics.

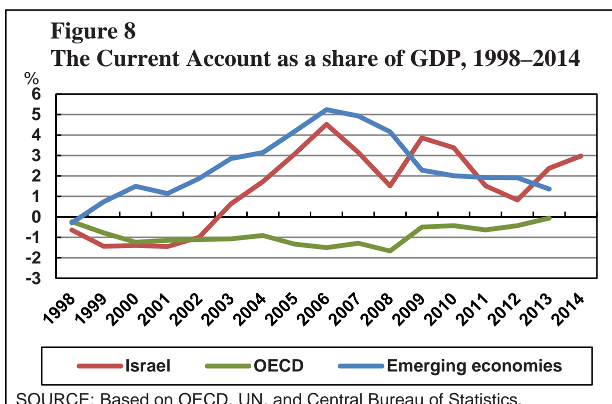


Figure 8
The Current Account as a share of GDP, 1998–2014

SOURCE: Based on OECD, UN, and Central Bureau of Statistics.

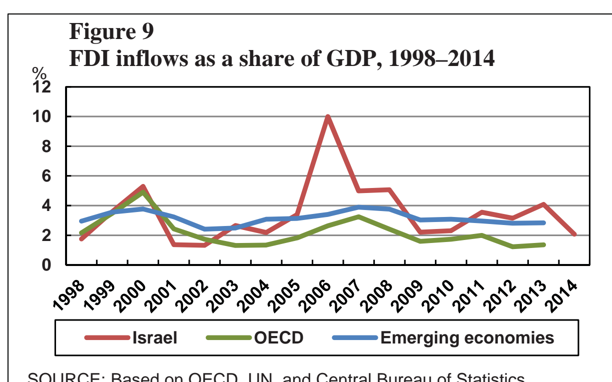


Figure 9
FDI inflows as a share of GDP, 1998–2014

SOURCE: Based on OECD, UN, and Central Bureau of Statistics.

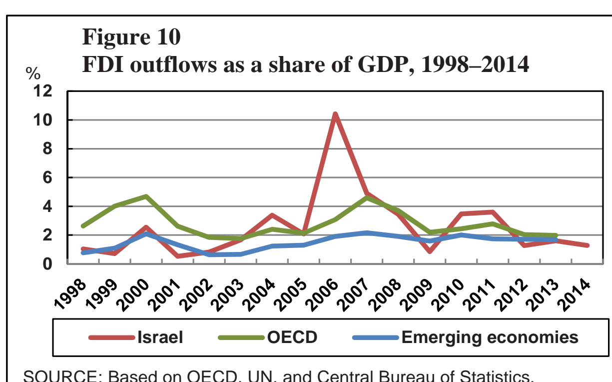


Figure 10
FDI outflows as a share of GDP, 1998–2014

SOURCE: Based on OECD, UN, and Central Bureau of Statistics.

D. Conclusion

The basic account is an accepted aggregate for analyzing data about the economy's balance of payments. According to its accepted definition, the basic account includes the current account surplus and net inflows and outflows of direct investments—elements that are more affected by long-term changes in the economy's fundamental data, and less by short-term financial considerations. The basic account in Israel went from balance to surplus in 2004, a surplus that was maintained continuously through 2014.

This transition to a surplus was related to many structural changes that occurred in the economy, headed by the consolidation of the high-tech industry, which contributed to both the creation of a current account surplus and a substantial increase in the flow of direct investment. We found that the level of direct investment inflows and outflows was linked to the business cycles in the economy, and to domestic and global growth. The ongoing basic account surplus was reflected in the imports of structural capital into the economy, which contributed to the appreciation of the shekel against other currencies.

The ratio of the basic account surplus to GDP in Israel is higher than the average in OECD countries, and is similar to the average in developing countries.

Looking ahead, natural gas—the discovery of the reservoirs and production of the natural gas for

domestic use and for export—constitutes a significant factor that will support the continuation of the basic account surplus, because it exerts an effect in the direction of both a current account surplus (more exports and fewer imports) and a rise in direct investments in the economy. The materialization of risks having a negative impact on domestic and/or global growth is liable to counter this trend.