Raising 200 billion NIS in Public Debt

Keren Harel-Hariri

The Repercussions of the Finance Ministry's 200,000,000,000 Shekel Bond Issue

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The Israeli government is planning to raise two hundred billion shekels this year and in 2010 (hundred billion shekels each year) by issuing government bonds. 140,000,000,000 shekels of this amount will be raised in the local market and 60,000,000,000 shekels will be raised abroad. Some of the amounts are intended to roll over debt from the years 2002-2003 whose repayment date has arrived, however 80,000,000,000 shekels constitute new debt.

The risks and shortcomings include the reality that the debts will effectively be recycled rather than retired; fresh debt will be added meaning that a new debt of 28,500 shekels will be imposed on each and every Israeli citizen; the relation between the debt and Israel's gross domestic product that already today totals 78%, one of the highest in the developed world will be aggravated; the rise in the above ratio can jeopardize Israel's adhesion to the countries of the European Union, who are obligated under the Maastricht Accord to maintain a debt ratio that does not exceed 60%; the raising of this capital can crowd out private businesses that require capital from the same markets (140,000,000,000 shekels will be raised local market); such a reality can raise the cost of capital (higher interest rates) and lead to bankruptcies in the Israeli economy; likewise, questions emerge regarding expanding the government at the expense of the private economy and the need for higher future taxes; all these can cloud the possibility for future growth.

It is possible that the Finance Ministry has conducted research before it decided to raise such high amounts. We assume that one should examine these studies or at least investigate the following questions before the measure is ratified: what will be the implications of the bond issue in the amount of 200,000,000,000 shekels on the local capital market, how will the relationship between debt to GNP change, how will this influence Israel's credit rating and its attempt to join international markets, and what occurred in the past in a situation when other countries attempted to raise similar amounts, especially during a period of crisis.

The Repercussions of the Finance Ministry's 200,000,000,000 Shekel Bond Issue

By Keren Harel Harari

__The Background__:

- **In the years 2009-2000 the Israeli government is expected to raise capital in the bond market in the unprecedented large amount** of 200,000,000,000 shekels - 100,000,000,000 each year. In the beginning of 2009 the government completed the raising of 40,000,000,000 shekels, and it intends to raise an additional 160,000,000,000 shekels by the end of 2010. In recent years the amount of capital raised by the government totaled 40-60 billion shekels per annum, so that in the next two years the government will effectively raise double the amount of capital.

- **We are dealing with a net rise of about 80,000,000,000 shekels**: out of 200,000,000,000 shekels nearly 120,000,000,000 shekels are intended to finance previous debts, and 80,000,000,000 shekels is intended to assume fresh debt. We are dealing with the largest extra raising of capital since the years of the 2002-2003 crises. The last time that Israel reached such a record raising of debt to the tune of 40,000,000,000 shekels per annum (an increase of net debt beyond repayment of previous debt) nearly triggered a financial crisis in 2002.

- **The rise in the amount of capital to be raised already stems from the crisis years 2002-2003**. Due to the severe economic conditions prevailing then, the government became mired in huge debts and was compelled to greatly increase its capital recruitment. A large part of the capital recruitment took the form of a series of bonds for a five or six year term, that fall due presently. Therefore the government is compelled to boost its capital recruitment in a drastic fashion in order to pay off old debts and this is even before it has begun to finance the new government debt.

- **A similar situation will be created in a number of years**, when the next generation will be compelled to pay off the debts that the government is assuming today, a new debt that the government is taking in order to pay off future deficits. This behavior by the government is consistent as this is how it has behaved beginning with 2002 till today (save for the years 2006 and 2007). The extent of the total capital recruitment in the year 2000 totaled 36,000,000,000 shekels whereas in 2008 the amount of capital raised has almost doubled, and totals 61,000,000,000 shekels.

- **The repercussions of the bond issues for the next two years are manifold, both in the short-term as well as in the long-term:**
- A rise in yields: a bond issue can influence market performance, and leads to fluctuations in the yields on bonds. There are grounds for apprehension that pressure on the bond market will increase and yields in the bond market will climb.
- High interest rates: the international money markets have as a result of the crisis entered into a state of paralysis, and anybody raising money has to pay relatively high interest rates. In the issue that the Finance Ministry performed in March of this year, it raised money abroad but at a higher interest rate than it could have risen in shekels in Israel, something that can shake the market.
- Impairment to corporate bonds: a massive increase in the amounts of bond issued abroad will find expression in depressed demand and hence a decline in corporate bond prices.
- Long-term interest: about 30% of the capital to be raised will be recruited in foreign money markets, and this can lead to be a rise in long-term interest rates in Israel and translate into a decline in investments in the Israeli private sector and accordingly a decline in the creation of job opportunities. The scenario can extend to the bankruptcy of firms, and a rise in unemployment rates as occurred in the United States at the close of the 1970s and the beginning of the 1980s.
- A burden on the future generation: since the issue of bonds constitutes in fact an increase in the external debt, one could compare these loans to the imposition of taxes on the future generation. In Israel there are about 7,000,000 residents, so that we and our children will carry a burden of 28,500 shekels as result of the bond issue of 200,000,000,000 shekels.
- Damage the image of the Israeli economy: An issue of such a huge size dims the prospects that Israel will enter the ranks of the European Union countries and increases the prospects that the country's credit rating will be lowered as has recently occurred in Great Britain.
- All the implications that were detailed above are detailed in expanded fashion in the attached document.

Statistical data about the debts of the Israeli government:

The size of the government debt during the years 2001-2007 (in billions of shekels)

year	Government debt
2001	447
2002	504
2003	523
2004	541
2005	553
2006	538
2007	524

Source: The Finance Ministry

Implications:

Immediate impact

- The report on the expected raising of 200,000,000,000 shekels in the bond market in 2009-2007 precipitated **sharp declines in the government bond market.** After it was reported on 19.5.09 that the Finance Ministry intended to issue bonds sharp declines were registered in long-term shekel bonds, that dropped by 2.8%. Long -term bonds linked to the cost-of-living index dropped by 2%.
- **There is apprehension that such an extensive capital recruitment will influence the performance of the Israeli bond markets that is already characterized by fluctuations**. During the course of May, before the bond issue was reported, the yields on bonds Israel government bonds rose by 0.5%-the increase that was registered represented a sharp rise in the course of a brief period, and it ensued despite the fact that the Bank of Israel is buying bonds in the market. In other words, the rise on the return is a result of the sale of bonds by the public-and in this fashion the public is expressing its lack of confidence in the country's financial conduct due to the budgetary crisis.

The Rise of Yields in the Market

- To the extent that there will be a sharp increase in the planned deficit in the state budget for the next two years - 6% and 5% in 2009 and 2010 respectively - pressure will mount on the bond market and there is apprehension that yields in the markets will rise.

- Senior figures in the capital market warned that irresponsible raising of capital abroad can shake the market in Israel if the Finance Ministry will issue bonds abroad at a higher interest than the interest provided in Israel, this will cause instability in the functioning of the Israeli bond market, and to fluctuations in the yields on government bonds in local capital markets, and it would be proper to be wary of this.

Lowered Demand and Influence on the Corporate Bond Market

- Government bonds can be expected to compete with corporate bonds. The government bonds are considered a more stable and less dangerous financial product than the corporate bonds. Therefore flooding the market with government bonds, which are more secure, will hurt the corporate bonds, and will induce a switch by some investors to purchasing government bonds and selling off the corporate bonds. This situation will also have implications on the condition of the pension and provident funds that are invested primarily in corporate bonds.
- A massive increase in the extent of bond issues abroad will find expression in lower demands and lower prices for the corporate bonds. Therefore it was decided by the Finance Ministry that 30% of the capital raising will take place in international money markets. The raising of capital abroad is in dollars, while government expenditures are in shekels. For the purpose of financing expenditures they will have to convert the dollars (or at least some of them) into shekels, this can lead to flooding the foreign currency market with dollars and lead to a upwards revaluation of the shekel, when the recommended policy is support for a devaluation of the shekel in order to stimulate exports and continued growth.

High Interest Rates

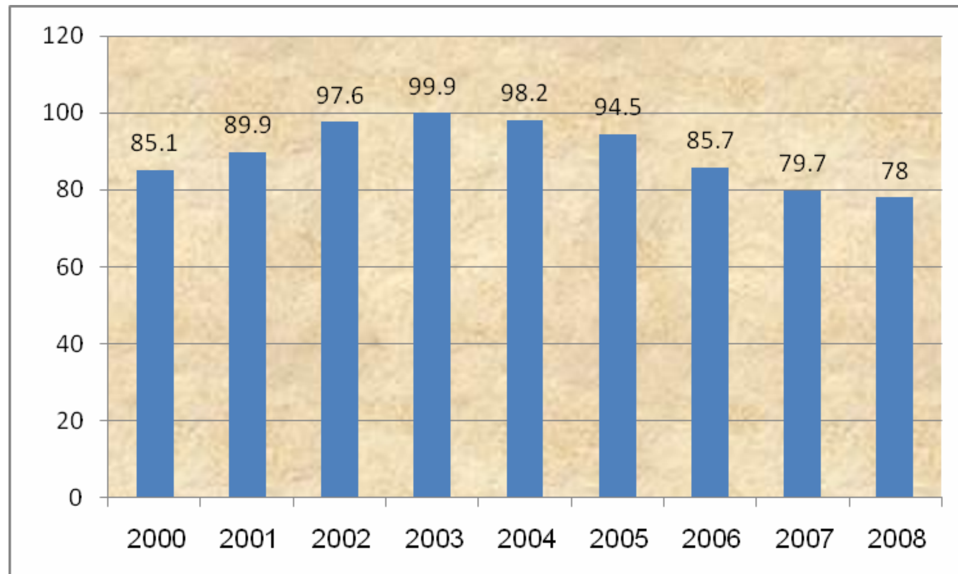
- In recent years Israel raised capital only locally and did not make any issues in the international markets, at the outset because of a desire to minimize exposure to foreign currency and subsequently due to the sub-prime crisis. A renewal of Israeli bond issues abroad, after two years of total absence from these markets, involves an additional problem: the current state of the bond issue market abroad. The international capital markets in the wake of the crisis have entered a state of paralysis, and anyone who raises funds must pay relatively higher interest. In an issue that the Finance Ministry performed in March this year, it raised money abroad at a higher interest than it could have raised in shekels in Israel.
- Even if only a small portion of the government capital recruitment will be performed in international capital markets, this will trigger increases in long-term interest rates in Israel. According to the Cato Institute the expectation is that due to the economic crisis, and the state of government deficits, many governments throughout the world are going to issue trillions of dollars in new government bonds over the next few years. As result the interest rates offered by the governments will be higher in order to attract citizens to save rather

than spend, and invest their money in government bonds instead of corporate bonds. When people save more and consume less, the demand for products and services declines, less money is invested in R&D, and the expansion of new businesses, productivity declines, and as a result fewer new job opportunities are created. This scenario is likely to take place in Israel as well since 70% of the issue will be take place in the local market, in Israel.

Long-term Influence

- **Raising money via bonds will not avail the State of Israel in the long-term**: when the government relies on bonds, and on markets abroad, it in practice "steals" potential resources for investments in the private sector. Since the government constitutes a factor competing with the private sector on sources for investment, as soon as it issues bonds and borrows money it causes a rise in the price of capital for private companies, and **this is reflected by a decline in investments in the Israeli private sector and a pursuant decline in the creation of job opportunities**. This scenario is likely to include (especially given global present economic conditions) to the bankruptcy of companies, and a rise in unemployment rates. This happened in the United States during this late 1970s and early 1980s, until President Ronald Reagan assumed office and changed economic policy.
- The use of the money that the government will receive from bond issues is also important. Instead of investing the money directly in factors that create growth such as infrastructures, the government is accustomed to increase its expenses in the public sector. The experience of the 1990s instructs that when the state received assistance to absorb immigrants, the public sector grew a few times faster than the industrial and commercial sector, and government salaries swelled accordingly. From 1992-1997, the average salary in the public sector rose by 21%, as compared with about 10% in the industrial sector and only 1% in the commercial sector.
- According to research published by the Swiss Institute for Business Cycle Research-in order to achieve an increase in private investments, a stable macro and economic environments is required. Even if the government would have devoted all the money that it borrows for investments, this still would not have produced growth unless in tandem it would have reduced its expenditures and the bloated size of government while increasing the productivity and efficiency of the public sector.
- **Since the issue of bonds constitutes in practice an increase of external debt, one can compare these loans to the imposition of taxes on our children**, and on the future generation, because they are those that will be compelled to shoulder the burden of returning this debt in many years, just as we are compelled today to pay for the huge debts that were accumulated years ago. This is especially true in light of the fact that the fund-raising by the Israeli government is characterized by long-term redemption: about 88% of the external debt bears an original target redemption span higher than five years, and only about 12% has an original redemption span that is lower than five years.

- **An issue in such a large amount diminishes the possibility that Israel will join the list of European Union countries.** The (external) public debt limit on countries of the European Union under the Maastricht Agreement totals 60% of GDP. The average debt in the OECD countries totaled 61.5% of GDP in 2008 as opposed to 78% of GDP in Israel. An increase in the external debt in order to finance government expenses for consumption will only aggravate the ratio of these numbers.
- **The load of government debt in Israel in relation to GDP remains one of the highest ratios in the Western world and the return on principle and interest for the loan for them constitutes a heavy burden on the state budget and the Israeli economy in general**. Interest expenses on government debt totaled 35 billion shekels in 2006, in 2007 34 billion shekels, and in 2008 34.5 billion shekels. Had the ratio between debt and GDP amounted to 60% in 2007, additional resources estimated at 9 billion shekels for the year 2009 would have been made available to the government. A reduction of the debt would have solidified the stability of the Israel economy in the event of local and external tremors, freed budgetary resources for current expenses at the expense of interest payments and would have readied Israel for contending with long-term changes. Public debt as a percentage of GDP in international comparison in 2008



Country	Total debt as a percentage of GDP
Romania	13.6
Luxembourg	14.7
Slovenia	22.8
Finland's	33.4
Sweden	38
Spain	39.5
Average for OECD countries	58
Holland	58.2
France	68
Hungary	73
Israel	78
Greece	97.6
Italy	105.8

Source: the Bank of Israel, Eurostat press office

Advantages/Response to the Apprehensions:

- **A comparison with the peak bond issue that occurred in 2002**: In 2002 the return on Shahar class shekel bonds skyrocketed to a record of 12.5%-a return that reflected fears that the State of Israel would go bankrupt. However, today Shahar class bonds are being traded with a yield of 5-5.2%. Additionally, the interest charged by the Bank of Israel is far lower than that which prevailed in 2002.
- The major expected rise in the government bond offerings in the next two years reinforces apprehension regarding a rise in bond yields. However, there is no certainty that the yields will actually rise, because one of the singular phenomena of the current economic crisis is that investors are barricading themselves behind government bonds, in the belief that this is the sole asset that remains a secure investment.
- **If necessary, the government can raise some of the money that it lacks abroad in the framework of the remaining loan guarantees** of the American government from 2003, in the sum of $3.8 billion. The use of the guarantee monies will allow the Finance Ministry to raise money abroad at a much lower cost than market prices.
- **Displaying a presence in the international capital and money markets**. For the past 2 1/2 years the government of Israel totally absented itself from these markets. The renewed bond issues will once again expose the Government of Israel to those active in the world capital markets. Likewise, the fluctuations in the margins of negotiable bonds provide an up to date indicator on the way that foreign investors view the Israeli economy and the performance by the Israeli government.
- **Creating a benchmark for issues by Israeli companies abroad**: the interests that will be set in the government bond issue will allow international

capital markets to price the interests that Israeli companies will be required to pay in the future if they wish to issue bonds abroad.

- **Creating an additional source for raising foreign currency thus increasing flexibility in the choice of sources for raising capital**. Likewise, the government by raising funds in the financial markets that employ foreign currency allows the government to use these monies to finance its expenditures in foreign currency, and finance the commercial deficit of Israel.
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Response by the Finance Ministry, the Accountant General:

"The expected size of the government deficit was not a secret. True the extent of the most sizable capital recruitment was unknown and these are figures that sound frightening-200,000,000,000 shekels-but as aforesaid the recycling of the debt was not expected to be too problematic." Yehoshua Oren, the Accountant General in *The Marker* 20.5 .09

- The Finance Ministry does not foresee a crisis in the bond market, and in its estimate a large part of the information on the increased capital recruitment by the state has a ready been taken into account in the bond prices. The rise in interest that occurred in the recent period, reflects the market expectation regarding the increased raising of capital by the Finance Ministry, and an additional rise in interest is possible.
    - The Finance Ministry is attempting to assume that it does not foresee any crisis in the bond market but does not conceal the fact that interest rates have already risen, and they will rise also in the future.
- One should refer primarily to the extent that government debt is being raised – in the amount of 80 billion shekels over two years rather than to 200 billion shekels, in other words only to net capital recruitment the amount that capital recruitment increased, and not merely to the replacement of old debt with new debt. The Finance Ministry estimates that the old bonds that are approaching redemption are generally rolled over into investments in new bonds. The Finance Ministry is getting ready to handle the large redemption of bonds, by replacing the old series of bonds with new series.
    - The new debt issue as well of 80 billion shekels contradicts Finance Ministry policy in the years 2006 and 2007 where the government reduced the debt and declared that "reducing public debt in Israel to a level similar to the OECD average constitutes a major objective in the fiscal policy of the government for the median term -- 2015."
- The comparison with the year 2002: we are dealing with a net recruitment of capital resembling that which we have already witnessed in 2002-2003, but then the state was close to a economic crisis. Today the conditions are easier: interest is low; the yields that rose sharply, already reflect to a large extent market expectations that they are about to increase the supply of bonds; and there is a tailwind from the direction of the Bank of Israel that is adopting an expansionary monetary policy, in whose framework it is buying government bonds on the market.

- True in 2002 the state of the economy was more severe and apprehension existed that the state was about to go bankrupt, and therefore drastic measures such as gigantic bond issue were taken. However despite the global crisis Israel today is in much better shape than it was in 2002 and therefore it is most problematic for the state to require such a sizable bond issue that will total the highest recorded level in the State of Israel's history.

- About 30% of the net capital recruitment will be financed from abroad, something that will reduce the pressure on the local market area and it has not yet been decided if the raising of capital will be performed in the framework of the American guarantees. Israel still has a quota of $3.8 billion in guarantees for raising capital hat but the Finance Ministry prefers approaching the international market first of all, and only if necessity arises to use these guarantees. If the guarantees will not be prolonged, they will elapse in the year 2011.
  - True 30% will be recruited abroad but still 70% will be issued in Israel. We are dealing with 70% of a gigantic issue of 200 billion shekels, and altogether 140 billion shekels that will be issued in local markets, about 70 billion shekels a year, a sum most appreciably higher than all the issues that took place in Israel from 2004 onwards.
- The accountant general assumes that there will yet be changes in the yields, but he does not know how to determine whether they will rise or decline. A large portion of the recent price declines on yield did not stem exclusively from the increased capital recruitment by the Finance Ministry, but also from a recovery in the corporate bond market and a move by investors from government bonds to corporate bonds. He noted that he is uncertain as to whether the capital market properly evaluates the risk in corporate bonds.
  - In other words the accountant general did not provide any forecast on what will be the result of the issue and whether the apprehension regarding the rise in yields will fulfill itself. He preferred to respond to the question of should one expect an additional decline in bond market prices in the following manner: "I am not an analyst of the market I believe that we will still see a change in yields, but they can rise just as they can climb". It is not certain that one should suffice with this determination. Those who set policy should give their attention to the significance of making important and complicated decisions without an exhaustive examination of the issue, by both the Finance Ministry as well as the Knesset. The bodies scrutinizing policy should first ascertain whether the Finance Ministry conducted regressions, prepared scenarios for the results, or conducted research that will demonstrate what could happen after such an issue, based on precedents abroad for recruiting such a large amount of capital on the local market, to the extent that they exist.
- The deficit increased due to the decline in tax collection and because the government did not make budget cuts. The more the deficit increases a greater debt burden will be imposed on the government, and this will have

heavy repercussions in terms of the cost of raising capital, the burden of future interest as well as the ability to raise money.

  - Therefore the Finance Ministry concedes that a situation has been created where the government deficit has increased and the burden of the debt on the government has also risen and this is prejudicial to the future capability of raising capital and the interest burden. Nevertheless, the significance of the decision to raise capital that is being discussed is that is has been decided to impose on every Israeli citizen, and especially on a child who belongs to the future generation, the onus of shouldering a debt burden of 200 billion shekels some of which has accumulated from previous years and some which will be paid off in the next years**.** As there are 7,000,000 residents in Israel, one can say that upon each and every one of us a future debt of about 28,500 shekels is to be imposed as a result of the intended bond issue.

Worldwide:

- **Injury to Israel's credit rating**: the bond issue constitutes in practice an increase in public debt as a percentage of GDP. A high national debt can lead to downgrades in the state's credit rating. This was the case with countries such as Spain, Ireland, Greece, Portugal, that as a result of their huge debt the credit rating companies reduced their rating, and this has been reflected in higher interest rates charged companies and households.
- Damage to Great Britain's credit rating: In 21.5.09 the Standard and Poor (S&P) rating company reduced Britain's credit rating from positive to negative, with a warning that it expects that Britain in the next two years could lose its credit rating currently ranked at the highest possible level AAA due to the country's national debt that is expected to total €1.4 trillion in the course of the next five years. As a result of which S&P placed British bonds on a watch list.
- The United States: apprehension was voiced in the United States that it too could lose its perfect credit rating. Despite this the American Treasury decided on May 26, 2009 to conduct a giant issue in an attempt to cover part of its huge deficit. The size of the issue set a new record and totaled $101,000,000,000. On the one hand there are those who argue that this was intended to guarantee that the return on the bonds that the government is selling will be very low, so that the financing of debts would be relatively low and will not increase the burden on the treasury's coffers. On the other hand Nick Kalivas the Deputy Director General for Financial Research in MF Global argues that the nexus between the decline in income from taxes and the huge size of government recovery programs government have led to a skyrocketing of money raising. In his opinion the similarity between the economies of the United States and Britain is great -raising apprehensions that the move to lower the credit rating in Britain will result in a similar downgrade in the United States as well.

- **An Undesirable Hike in Costs:**
- The rise in government bond yields can hinder global recovery, because it makes the costs of financing recovery programs in the United States, Britain and Germany more expensive by hundreds of billions of dollars. Governments find themselves in the same condition as consumers in a recession: they pay a higher interest on increasing indebtedness. A rise of 1% in the return on bonds will cost the American treasury $50,000,000,000 per annum in financing expenses and subsequently about hundred and $70,000,000,000 per annum. This situation creates unprecedented pressure on the budget, and can injure social and defense programs. Likewise it can hinder growth because it will lead to a rise in interest on the debt of households, consumers and homeowners.
- From the end of 2008, the return on US 10 year Treasury bonds rose by 1.5% to 3.54%. This was the sharpest increase in the last 15 years, although the current yield is still lower by historical yardsticks. At the same time, the return on German 10 year bonds rose from 2.93% to 3.57%.
- The cost of issuing additional bonds is the price that the government is prepared to pay in order to extricate from the recession, in the hope of returning to fiscal and economic health that will increase income from taxes and will allow redemption of debts. The last three weeks, the increased rise in the rate of returns was accelerated due to the evaluation of the Congressional Bureau of the Budget that government debts will expand to 65% of the GDP by September 2010, as opposed to 41% in September 2008
- According to Citigroup in 2009-2010 the American administration will sell more than $5,000,000,000,000 in new bonds. According to the Congressional Budget Bureau in another decade America's debts can reach 82% of GDP-$17,000,000,000,000.
- This is a huge problem says Kenneth Rogoff professor of economics at Harvard who is now writing his new book This Time It Is Different: Eight Centuries of Financial Folly own clothes the situation exposes us severely to a global rise in interest rates that can get out of control." The long-term forecast is very frightening, because the rise in financing costs will aggravate and will lead to record deficits.