

Chapter 4

The External Debt and Israel's Credit Risk

Israel's credit risk is believed to have increased in 2002 due to the worsening state of the economy. However, the low level of the external-debt and credit-risk indicators from a long-term perspective gives evidence of the economy's financial strength, which was also reflected in the international rating companies' decision not to lower Israel's sovereign rating.

Some of the credit-risk indicators suggest that Israel's credit risk has increased; others show the opposite. The gross external debt/GDP ratio rose for the second consecutive year. Although the rating companies left the sovereign rating unchanged at a strong A-, over the past two years they have changed their credit rating outlook from positive to stable or from stable to negative. The spread of Israel Government tradable bonds over US Treasury notes (the credit-risk premium) rose in the last quarter of 2002 but slipped back at year's end. The ratios of *net* external debt to GDP and of short-term assets to total short-term external debt improved, and the latter ratio, high to begin with, continued to rise for the second consecutive year.

The trend in external debt and external assets in 2002, and the changes in their composition, reflect an upturn in the country's credit risk. For example, the uptrend in the external debt accelerated and in 2002, for the first time, nonresidents made net withdrawals from their deposits with banks in Israel. On the assets side, external assets of the nonbanking private sector, foremost in foreign bonds and external bank deposits, continued to expand.

1. THE EXTERNAL DEBT TREND IN 2002

The external debt is a vastly important indicator in analyzing the financial strength of developing economies. The financial crises in Southeast Asia in 1997 and 1998 accentuated the importance of discussing external debt because the information about these countries' external debt was incomplete. The centrality of external debt became clearer than ever in 2002 due to the difficulty in raising external sources for the economy and due to perceptible concern about a lowering of the sovereign rating.

The trends in the components of the external debt and external assets give an indication of the changes in Israel's credit risk. In the banking system, for example, the decrease in nonresident deposits and the upturn in deposits from banks abroad show, among other things, that the credit risk has worsened. On the assets side, the increase in resident deposits with foreign banks may, among other things, indicate that residents' perception of the riskiness of their country has changed.

a. Gross external debt

Growth of the gross external debt accelerated in 2002.

Israel's outstanding gross external debt was \$ 66 billion at the end of December 2002, up by \$ 2.1 billion (3.3 percent), after a \$ 0.3 billion increase in 2001. The significant acceleration in debt accumulation in 2002 traces mainly to issues of Israel Bonds and tradable government bonds abroad¹ and an increase in foreign banks' deposits with the Israeli banking system (Table 4.1).

Table 4.1
Israel's Gross and Net External Debt,^a 1998–2002

	<i>(balances, \$ billion)</i>				
	31.12.1998	31.12.99	31.12.2000	31.12.01	31.12.02
Israel's gross external debt					
Public sector	27.4	27.5	27.2	26.7	27.1
Nonbanking private sector	11.5	13.1	13.9	13.6	14.5
Banking system	19.1	21.2	22.7	23.8	24.6
Total	58.1	61.8	63.8	64.1	66.2
Israel's assets abroad^b					
Public sector	23.2	23.4	24.0	24.0	24.6
Nonbanking private sector	10.4	13.4	16.3	20.4	25.4
Banking system	13.2	14.3	15.7	15.6	15.6
Total	46.8	51.0	56.0	60.0	65.5
Israel's net external debt					
Public sector	4.3	4.1	3.3	2.8	2.5
Nonbanking private sector	1.2	-0.2	-2.5	-6.9	-10.9
Banking system	5.9	6.9	7.0	8.2	9.1
Total	11.3	10.8	7.8	4.1	0.7

^a Israel's external debt and assets include direct credit (including commercial credit), bonds, and deposits.

^b Debt instruments and the Bank of Israel's foreign exchange reserves.

SOURCE: Based on reports from banks, companies, and the Ministry of Finance.

The outstanding *tradable external debt* was \$ 19 billion in 2002—28 percent of the total gross debt, a proportion that has not changed significantly in the past three years. This high level of tradable debt reflects Israel's integration into the global financial markets but also exposes the quality of the country's economic policy to constant review by parties abroad.

¹ The 'tradable government and nonbanking private-sector bonds' line in the external-debt data does not include bonds that were acquired by residents. These acquisitions are also excluded from the assets side because they reflect activity among residents.

(1) The public sector

The gross external debt of the public sector was \$ 27.1 billion at the end of 2002, \$ 0.3 billion (1.2 percent) greater than the year-earlier level. In 2002, the government raised \$ 1.7 billion abroad (gross), most of which by means of Israel Bonds, in which a record \$ 1.4 billion was issued as against an annual average of \$ 0.9 billion in the previous five years. The government also raised 400 million euros in February 2002 in a seven-year bond issue.

Israel Bonds raised a record \$1.4 billion this year.

In 2002, as in all years since the end of the US Government loan-guarantee arrangement, Israel Bonds were the main source of external government capital-raising. The government's difficulty in raising tradable capital, coupled with the willingness of American Jews to help Israel in 2002—due to the security situation and the terror onslaught against the United States—created a convenient climate for Bonds activity. Thus, the value of outstanding Israel Bonds was \$ 9.6 billion at the end of 2002, 35 percent of the government's outstanding external debt. The strong performance of Israel Bonds was accompanied by large redemptions, at \$ 1.1 billion in 2002 as against an annual average of \$ 0.6 billion in the previous five years. *Net* issues (gross issues less redemptions) of Israel Bonds have been in the vicinity of \$ 0.3 billion in recent years. In the past two years, the government has encouraged investors to purchase Israel Bonds by raising the yield on fixed-interest instruments of this type. The average spread of ten-year Jubilee bonds over US Treasury notes was 160 basis points in 2002 as against 130 basis points in 2000. The decline in long-term dollar interest rates in the past two years surpassed the increase in spread on Israel Bonds. The short-term dollar interest rate declined even more steeply than the long-term dollar interest rate and became very low. For this reason, purchasers of Israel Bonds preferred the fixed-interest Jubilee to bonds that pay floating interest based on LIBOR. As a result, the proportion of Jubilee bonds in total sales of Israel Bonds has been rising steeply and steadily, from 10 percent in 1998 to 60 percent in 2002.

(2) The nonbanking private sector

The outstanding gross external debt of the nonbanking private sector was \$ 14.5 billion in December 2002, about \$ 1 billion higher (7.0 percent) than the year-earlier level. Most of the increase occurred in suppliers' credit; in previous years, overseas issues of tradable bonds were the main source of external capital for this sector. Outstanding issues abroad were \$ 5.7 billion at the end of 2002, but since \$ 1.4 billion was held by residents, only \$ 4.3 billion—the amount held by nonresidents—was charged to the external debt. In view of the security unrest and the economic situation, only \$ 0.1 billion was raised by means of bond issues in 2002 as against \$ 0.9 billion in 2001 and a record \$ 1.5 billion in 2000. Most of the issues abroad were made by one company.

(3) The banking system

External liabilities of the banking system were \$ 24.6 billion in December 2002, \$ 0.8 billion (3.5 percent) higher than the year-earlier level. The upturn in 2002 was the result of an increase in foreign banks' deposits with the Israeli banking system. Demand for forex credit from the banking system increased during the period reviewed

The balance of nonresident deposits decreased for the first time in twenty years due to net withdrawals.

while forex sources from the public (resident and nonresident deposits) did not climb apace. This asymmetry forced the banking system to solicit larger deposits from foreign banks and, especially, from its foreign branches. Total nonresident deposits from the public were \$ 21.3 billion at the end of 2002, declining slightly after steady nominal growth in all previous years. Examination of net flows in the account, exclusive of exchange-rate differentials, points to net withdrawals—the first ever—of \$ 0.8 billion (Figure 4.1).

b. Israeli debt assets (instruments) abroad

Israeli assets abroad increased by a record \$5.5 billion.

Israeli debt assets abroad—credit to borrowers abroad, external deposits, and foreign reserves kept with the Bank of Israel—were \$ 65.5 billion in December 2002, surpassing the year-earlier level by \$ 5.5 billion (9.3 percent). The increase in Israeli assets abroad was composed of the upturn in assets of the nonbanking private sector and public sector abroad; in the banking sector this indicator was unchanged.

External assets of the *nonbanking private sector* climbed to a record \$ 25.4 billion at the end of 2002—an increase of \$ 4.9 billion, similar to the upturn in 2001. Most of the increase in 2002 occurred in investments in foreign bonds (up by \$ 2.5 billion) and deposits with banks abroad (\$ 1.8 billion; for detailed discussion, see Chapter 2).

Public sector assets increased by \$ 0.6 billion in 2002, mainly due to price changes and exchange-rate differentials. Net of these effects, general government assets decreased by \$ 1.3 billion.

c. Net external debt and net short-term debt

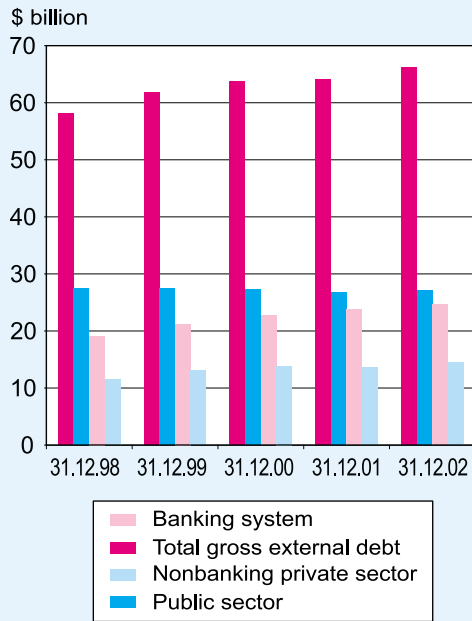
The net external debt fell to a very low \$0.7 billion.

Since the growth of Israeli debt assets abroad has been outpacing the increase in external debt in recent years, the *net external debt* has been declining and came to a very small \$ 0.7 billion at the end of 2002. This is part of a trend that began in late 1995, when the net external debt was about \$ 20 billion (Figure 4.2).

The short-term assets surplus climbed to a record \$21 billion.

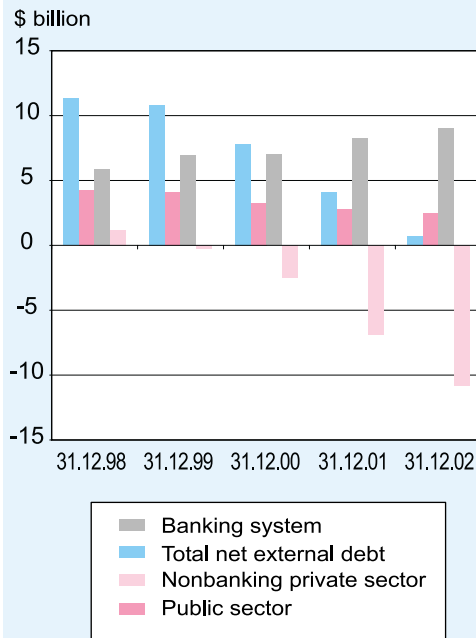
The Israeli economy has a rather large surplus of short-term external assets (short-term assets less short-term debt). In 2002, the surplus climbed perceptibly, by \$ 1.8 billion, and ended the year at a record \$ 21 billion. The structure of the external debt and external debt assets (instruments) in respect of terms to maturity/realization is very important in judging the financial strength of the economy and its ability to repay debt in the short term. The high level of foreign reserves and the increase in nonbanking private-sector assets abroad are contributing factors in Israel's large surplus in short-term assets. The combination of the robust surplus and the small net external debt did much to persuade the international rating companies not to lower Israel's sovereign rating.

Figure 4.1
Israel's Gross External Debt, by Sector, Dec. 1998- Dec. 2002



SOURCE: Based on data from the Accountant-General, Ministry of Finance, banks, and companies.

Figure 4.2
Israel's Net External Debt, by Sector, Dec. 1998- Dec. 2002



SOURCE: Based on data from the Accountant-General, Ministry of Finance, banks, and companies.

2. CREDIT RISK AND CREDIT RATING

Credit risk is the most important financial risk in nonresidents' perception of an economy's strength. Credit risk is estimated by means of objective indicators such as ratios of the external debt and its composition and by subjective indicators that reflect nonresidents' judgment, such as risk premium and credit rating (Table 4.2). Analysis of the risk indicators shows that Israel's credit risk rose in view of several indicators and declined in view of others. For example, the gross external debt/GDP ratio rose but the net external debt/GDP ratio declined.

The *gross external debt/GDP ratio* climbed from 60 percent at the end of 2001 to 65 percent a year later, for the second consecutive year of upturn (Figure 4.3). This ratio, one of the most important objective indicators, plays an important role in estimating the economy's credit risk.

The *net external debt/GDP ratio*, an indicator that points to a decline in Israel's credit risk, continued to fall in 2002 and ended the year at only 1 percentage point (Figure 4.3) as Israel's external assets grew more vigorously than its external liabilities.

Table 4.2
Indices of Israel's External Credit Risk and Rating, 1994–2002

	<i>(end period, percent)</i>								
	1994	1995	1996	1997	1998	1999	2000	2001	2002
External debt (assets) ratios									
Gross debt/GDP	58	56	52	55	62	60	55	60	65
Assets/GDP	34	32	33	40	50	50	49	56	64
Net debt/GDP	25	23	19	15	12	11	7	4	1
Short-term ^a debt/gross debt	44	46	43	41	40	41	43	43	43
Short-term ^a assets/total assets	87	86	87	87	88	86	82	78	75
Short-term ^a assets/short-term debt	114	109	126	156	176	171	169	170	175
Reserves/short-term ^a debt	35	38	53	91	97	88	85	84	84
Credit rating									
Standard & Poor's	BBB+	A–	A–	A–	A–	A–	A–	A–	A–
Moody's		A3	A3	A3	A3	A3	A2	A2	A2
Fitch	BBB+	A–	A–	A–	A–	A–	A–	A–	A–
Institutional Investor ^b	47	49	52	53	53	56	64	60	59
Euromoney ^b	72	76	76	77	76	71	73	72	69
Spreads									
Government dollar bond spread (basis points)							215	135	140

^a Short-term: maturing (realizable) in up to one year.

^b A grade out of 100 points (100 points = no risk).

SOURCE: Bank of Israel and Central Bureau of Statistics data.

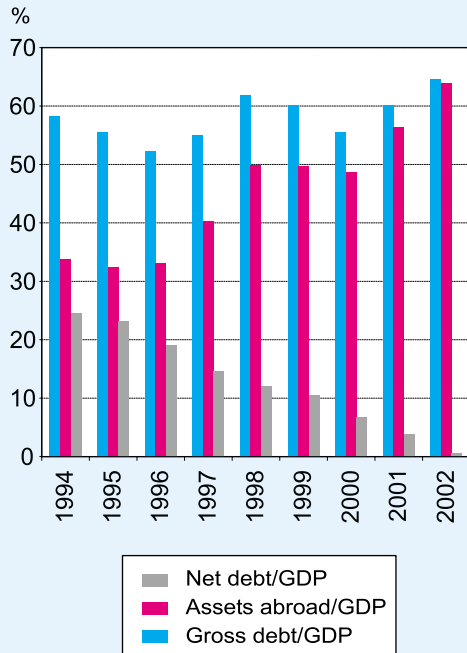
The gross external debt/GDP ratio increased for the second straight year. The net external debt/GDP ratio fell to its lowest level ever.

The increase in Israeli assets abroad was also reflected in the *external assets/GDP ratio*, which continued to climb, from 56 percent at the end of 2001 to 64 percent a year later.

Another indicator of declining credit risk is the *short-term external assets/short-term external debt ratio*. This ratio, which expresses the country's ability to cover short-term external debt by means of foreign reserves in the event of a currency crisis, climbed from 170 percent at the end of 2001 to 175 percent a year later (Figure 4.4). The *foreign reserves/short-term external debt ratio* was 84 percent at the end of 2002, unchanged from a year earlier. The structure of Israel's external debt and external assets (debt instruments), in terms of their term to maturity/realization, is vastly important in assessing the financial strength of the economy and its ability to repay debt in the short term. One effect of these ratios in 2002 was their contribution to the international rating companies' decision not to lower Israel's sovereign rating.

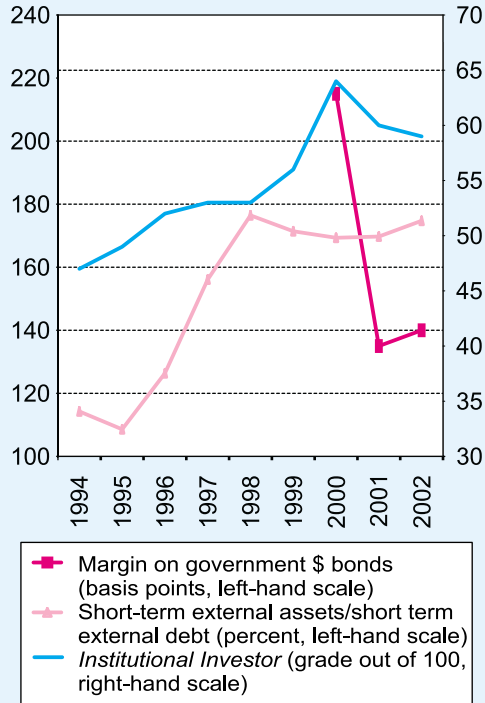
A subjective indicator of an increase in Israel's credit risk was a downturn in the outlooks (forecasts) of the rating companies. S&P lowered its Israel outlook in October 2000 from positive to stable and from stable to negative in April 2002; Moody's lowered its outlook from positive to stable in February 2001. These forecasts express the possibility of a downgrading of Israel's sovereign rating in the future. Although the outlooks changed, S&P and Fitch left the sovereign rating at a solid A- and Moody's kept its rating firm at A2. Notably, however, in January 2003 Moody's downgraded the rating of the Israel Electric Corporation by two notches, from A3 to Baa2, for reasons including financial losses occasioned by currency depreciation. In February 2003, S&P downgraded the IEC by one notch, from A– to BBB+.

Figure 4.3
Indices of External Credit Risk:
External Debt/GDP, 1994-2002



SOURCE: Based on data from the Accountant-General, Ministry of Finance, banks, and companies.

Figure 4.4
Indices of External Credit Risk, 1994-2002



SOURCE: Based on data from the Accountant-General, Ministry of Finance, banks, and companies.

The assessment of Israel's country risk is reflected in market yields on Israel Government bonds. The risk premium for credit is measured by means of the spread of Israel Government dollar-denominated bonds over US Treasury notes. The spread of Israel's 'global' bonds was 140 basis points in December 2002, similar to the December 2001 level. The spread fluctuated during the year, climbing to 170 basis points in September and retreating in late December.

