

## *Chapter 4*

# *International Investment Position and External Debt of the Israeli Economy*

This chapter examines the composition of Israel's assets and liabilities vis-a-vis the rest of the world in terms of the types and tradability of the assets, with special emphasis on developments in the external debt due to its special importance.

### 1. BALANCE OF EXTERNAL ASSETS AND LIABILITIES

#### **External liabilities**

Gross external liabilities increased by \$ 12 billion in 2004 and amounted to \$ 135 billion at year's end (Table 1.4.1). Most of the change traced to an increase in net nonresident portfolio holdings of shares and bonds and reflects a relative increase in nonresident holdings of tradable instruments. Furthermore, the proportion of capital instruments held by nonresidents increased at the expense of debt instruments.

#### **External assets**

External assets amounted to \$ 100 billion at the end 2004 as against \$ 88 billion a year earlier (Table 1.4.1). Direct investment and deposits abroad of Israeli banks, increased perceptibly. The proportion of capital instruments held by Israelis rose at the expense of debt instruments and the proportion of tradable assets declined.

#### **Net external liabilities**

Net external liabilities remained unchanged at \$ 35 billion during the review period (Table 4.1).

**Table 1.4.1**  
**International Investment Position (IIP), 2001–2004**

	(end-period balances, \$ million)			
	2001	2002	2003	2004
<b>Assets</b>				
Total assets	72,618	78,085	88,364	99,964
<i>Of which:</i> debt instruments	65,321	70,277	77,262	85,500
Direct investment abroad	9,249	10,319	13,063	16,010
Portfolio investment	7,975	10,181	13,750	15,976
Other investment abroad	30,970	32,657	34,325	40,280
Public-sector assets abroad	24,424	24,928	27,226	27,699
<b>Liabilities</b>				
Total liabilities	107,458	104,537	123,505	135,097
<i>Of which:</i> debt instruments (external debt)	65,106	67,653	71,177	73,633
Direct investment	24,764	24,750	31,660	33,156
Portfolio investment	37,646	32,703	43,312	53,113
Other investment	45,049	47,084	48,532	48,829
Net liabilities	34,840	26,452	35,140	35,133
<i>Of which:</i> net debt instruments	-215	-2,623	-6,085	-11,867

SOURCE: Ministry of Finance, companies, banks, Israel Securities Authority, and BOI calculations.

## 2. EXTERNAL DEBT

This section expands the discussion of developments in Israel's external debt due to the centrality of external debt in nonresidents' assessments of country risk. A clear uptrend in external debt (especially in net short-term debt) may deter nonresidents from financing additional debt and impair Israel's ability to recycle or raise debt for long terms.

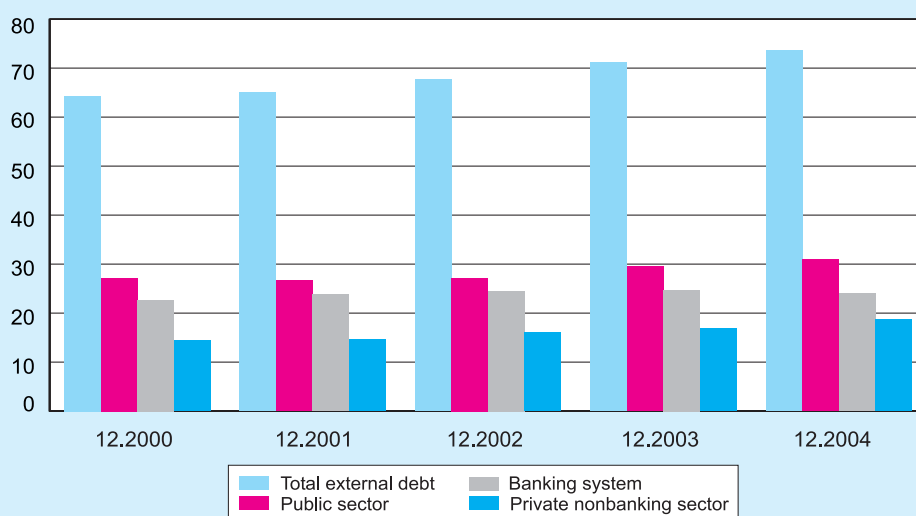
### Gross domestic external debt

Outstanding gross external debt was \$ 74 billion at the end of 2004, up by \$ 2.4 billion during the year as against a \$ 3.5 billion increase in 2003 (Figure 1.4.1, Table 1.4.2). The gross debt/GDP ratio continued to decline (in dollar terms) during the review period and came to 60 percent in 2004 as against 65 percent in 2002 (Table 1.4.5).

The tradable share of the total gross external debt was 30 percent in 2004 as against 28 percent at the end of 2003. This reflects Israel's continued integration into global financial markets and attests to the ability of the various sectors of the economy to raise debt abroad. Outstanding short term external debt came down to \$ 29.8 billion during 2004.

The tradable share of total gross external debt has been rising in recent years, reflecting Israel's continuing integration into international financial markets.

**Figure 1.4.1**  
**Israel's Gross External Debt, by Sector, December 2000–December 2004**  
 (\$ billion)



SOURCE: Based on data of the Accountant General, banks and companies.

**Table 1.4.2**  
**Gross and Net External Debt Balances and Forward Amortization,<sup>a</sup> 2003–2004**  
 (balances, \$ million)

	Total balance 31.12.03	Maturity		Total balance 31.12.04	Maturity	
		Within a year	Over a year		Within a year	Over a year
<b>Gross external debt</b>						
Public sector	29,570	2,994	26,576	30,877	2,488	28,389
Nonbanking private sector	16,862	7,695	9,167	18,742	8,186	10,556
Banking system	24,745	19,286	5,459	24,014	19,162	4,852
Total	71,177	29,976	41,201	73,633	29,836	43,797
Percent	100	42	58	100	41	59
<b>Assets abroad<sup>b</sup></b>						
Public sector	27,280	27,094	185	27,742	27,565	177
Nonbanking private sector	32,001	18,781	13,221	35,918	20,437	15,481
Banking system	17,981	12,754	5,227	21,839	17,087	4,752
Total		58,629	18,633	85,500	65,089	20,411
Percent	100	76	24	100	76	24
<b>Net external debt</b>						
Public sector	2,290	-24,101	26,391	3,135	-25,077	28,211
Nonbanking private sector	-15,139	-11,085	-4,054	-17,176	-12,251	-4,925
Banking system	6,764	6,533	231	2,175	2,075	100
Total	-6,085	-28,653	22,568	-11,867	-35,253	23,386

<sup>a</sup> Israel's external debt and assets include direct credit (including trade credits), bonds, and deposits.

<sup>b</sup> Debt instrument assets and the Bank of Israel's foreign exchange reserves.

SOURCE: Ministry of Finance, companies, banks and BOI calculations.

## External debt of general government

The outstanding gross external debt of public sector was \$ 31 billion at the end of 2004, up \$ 1.3 billion during the year. The government was the main borrower, accounting for 41 percent of the total gross debt at the end of 2004. During the year, the government raised debt abroad by issuing \$ 3.5 billion in bonds (negotiable and non-negotiable) and making \$ 2.7 billion in bond redemptions (Table 1.4.3). In 2003, the United States Government approved \$ 9 billion in guarantees for Government of Israel bond issues over a four-year period. In 2004 the term was extended to six years, giving the government greater flexibility in planning its issues in view of needs diminishing time constraints. In 2004, the government used the guarantees to issue

**Table 1.4.3**  
**Net Government Borrowing Abroad, 2001–2004**

	(\$ million)			
	2001	2002	2003	2004
Total borrowing	1,542	1,734	4,670	3,499
Bonds guaranteed by the US government	0	0	2,350	1,750
Unguaranteed bonds	162	350	750	500
State of Israel bonds (nontradable)	1,145	1,310	1,569	1,249
Foreign banks	234	75	1	–
Repayment	2,139	2,165	3,052	2,706
Net borrowing	–597	–431	1,618	792

SOURCE: Accountant General's Office in the Ministry of Finance and BOI Foreign Exchange Activity Department calculations.

\$ 1.75 billion in twenty-year bonds (in addition to \$ 2.35 billion issued in 2003). The bonds pay 5.3 percent annual interest, at an average yield of 30 basis points over U.S. Treasury Bonds. The tradable share of the total government external debt was 58 percent at the end of 2004, 2 percentage points up from a year earlier. This proportion is expected to continue rising in coming years as the guarantees continue to be utilized.

In addition to issues of negotiable bonds in 2004, the government raised \$ 1.25 billion in non-negotiable bonds under the Israel Bonds program and made \$ 1.5 billion in redemptions. Most of the bonds sold this year were five and ten-year Jubilee Bonds that pay 4.3 percent and 5.4 percent interest, respectively (90 and 110 basis points over U.S. Treasury Bonds, respectively). The balance of Israel Bonds was \$ 10 billion at the end of 2004, one-third of the total gross external debt of general government. In March 2004, the government also raised \$ 500 million in “Global” bonds in the open market, for ten years at 5.1 percent interest (115 basis points over U.S. Treasury Bonds).

### The cost of the external national debt

The average cost of raising government debt abroad in 2004 was 5.1 percent, similar to the previous year (Table 1.4.4). The total cost was calculated by weighting the costs of various instruments—bonds guaranteed by the U.S. Government, non-negotiable Israel Bonds, and negotiable bonds in international capital markets. The cost is affected by Israel's risk rating, changes in interest rates on negotiable bonds, and the interest rates that are set for Israel Bonds. The average interest rate on the outstanding debt of general government was 6 percent in 2004, largely unchanged from 2003. Notably, the rate remained stable even though long-term interest rates in the U.S. rose by 0.3 percentage points in 2004 after having trended down for three years.

**Table 1.4.4**  
**Government External Dollar Debt: Average Interest Rates and Maturity, 2000–2004**

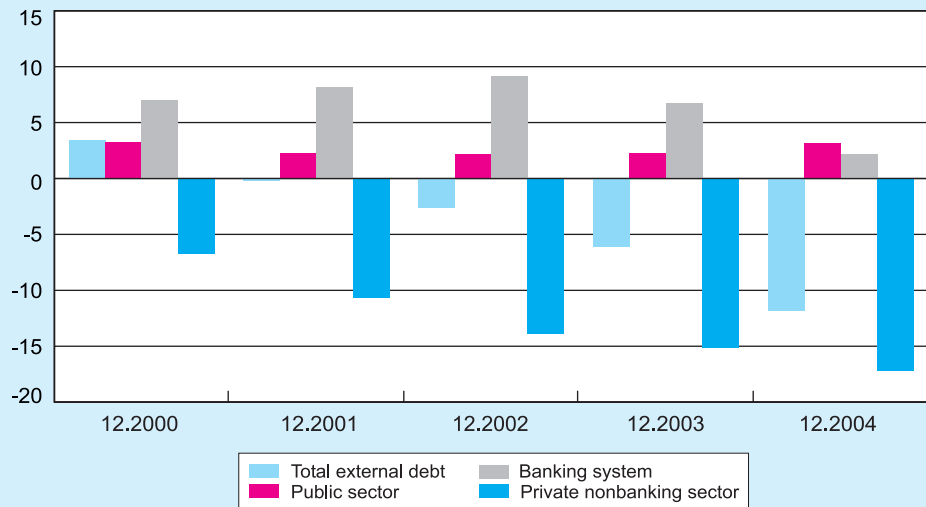
	2000	2001	2002	2003	2004
Average interest rates on loans received during year (%)	7.5	5.4	5.4	5.1	5.1
medium-term borrowing	7.3	5.2	4.7	3.9	3.9
long-term borrowing	7.6	5.7	5.9	5.3	5.3
Average maturity of loans received (years)	8	7	7	15	14
Average interest rate on end-year outstanding debt (%)	7.3	6.4	6.3	6.1	6.0
International interest rates (% , annual averages)					
6-month USD Libor	6.7	3.7	1.9	1.2	1.8
US 10-year T-Notes	6.0	5.0	4.6	4.0	4.3
US 20-year T-Bonds	6.2	5.6	5.4	5.0	5.1

SOURCE: Accountant General's Office in the Ministry of Finance and BOI Foreign Exchange Activity Department calculations.

### Servicing the external national debt

In accordance with the new U.S. guarantees agreement that was approved in 2003, bonds issued by the Government of Israel pay interest every half-year. In the next four years, payback of principal and interest on account of these bonds is expected to be around \$ 3.7 billion per year. The average term of total issues was fourteen years in 2004 as against fifteen years in 2003 and seven years in 2000–2002. The prolongation of the term of issues in the past two years is the result of new long-term issues under the guarantees program and the repayment of medium-term loans.

**Figure 1.4.2**  
**Israel's Net External Debt, by Sector, December 2000–December 2004**  
 (\$ billion)



SOURCE: Based on data of the Accountant General, banks and companies.

### External debt of the nonbanking private sector

The non-banking private sector had \$ 19 billion in gross external debt at the end of 2004, up 11 percent from the year-earlier level. Most of the increase traced to an upturn in net direct borrowing from abroad. It should also be noted that semi-Israeli firms and foreign subsidiaries of Israeli firms made rather large issues during the year. This activity, however, is not counted in the reckoning of assets and liabilities vis-a-vis the rest of the world.<sup>1</sup> Net direct external borrowing—loans from foreign banks, equity-holders' loans, and loans from foreign firms—was \$ 1.6 billion in 2004 as against negligible sums in the two previous years. This development is compatible with the recovery and growth of the business sector in 2004 and the global trend of capital issues in emerging markets, that benefited from a strong inflow of investment from developed countries at relatively low prices.

### External debt of the banking system

The banking system had \$ 24 billion of outstanding external debt at the end of 2004, \$ 0.7 billion less than the year-earlier level. Most of the decrease is traced to a decline in deposits of Israeli banks' subsidiaries with the banking system. In deposits by nonresidents (the public), a turnaround occurred during the year reviewed: the net

<sup>1</sup> See expanded discussion in Chapter 3.

withdrawal trend that began in mid-2001 halted and net depositing with Israeli banks resumed in September. As a result, the balance of nonresident deposits was unchanged during 2004. The turnaround seems to have been prompted mainly by an increase in the interest rate on these deposits, from 0.7 percent at the end of the first quarter of 2004 to 1.9 percent at year's end.

### External domestic assets (debt instruments)

Israel's debt assets—lending to borrowers abroad, external deposits, and the foreign reserves—amounted to \$ 85 billion at the end of 2004, up by \$ 8.2 billion (10 percent) from the year-earlier level. The increase in domestic debt assets (debt instruments) abroad was due largely to a steep upturn in the external deposits of Israeli banks.

*The nonbanking private sector* built up its external assets (debt instruments) by \$ 4 billion during the year, bringing the balance to a peak of \$ 36 billion by year's end. The increase was composed largely of investments in foreign bonds (\$ 1.4 billion), deposits with foreign banks (\$ 1.1 billion), and customer credit (\$ 0.5 billion) in view of the upturn in exports.

*The banking system* increased its external assets by \$ 3.9 billion during the year, reflecting an upturn in deposits with foreign banks due to forex surpluses accumulated during the year. The surplus sources originate in an increase in net forex depositing by residents (businesses and individuals) and repayment of forex credit by residents and nonresidents in view of the narrowing spreads.

*The reserve assets* in the Bank of Israel increased by \$ 0.8 billion during the year due to exchange-rate changes and the depositing of some proceeds of the government's U.S.-guaranteed bond issues with the Bank of Israel.

### Net external debt

External assets (debt instruments) increased rapidly during 2004—by \$ 8.2 billion more than the growth of the external debt—bringing the balance of net external debt to a negative \$ 12 billion, twice the year-earlier level. Thus, the Israeli economy maintained its position as a net lender to the rest of the world.

The structure of the external debt and domestic debt assets abroad in terms of repayment schedule is very important in evaluating an economy's financial robustness. The larger the short-term debt, the greater the probability of default. Since the Israeli economy maintains a large surplus of short-term assets (debt instruments), its credit risk is relatively low. The short-term asset surplus was \$ 35 billion at the end of 2004, \$ 6.6 billion (23 percent) larger than the year-earlier level (Table 1.4.2). This is because most government debt is long-term while most private-sector assets (which increased substantially during the review period) and the reserve assets are short-term.

The coverage ratio of short-term assets to short-term debt improved considerably, to 218 percent at the end of 2004, and the coverage ratio of the reserve assets to

External domestic assets (debt instruments), especially deposits of Israeli banks, increased appreciably.

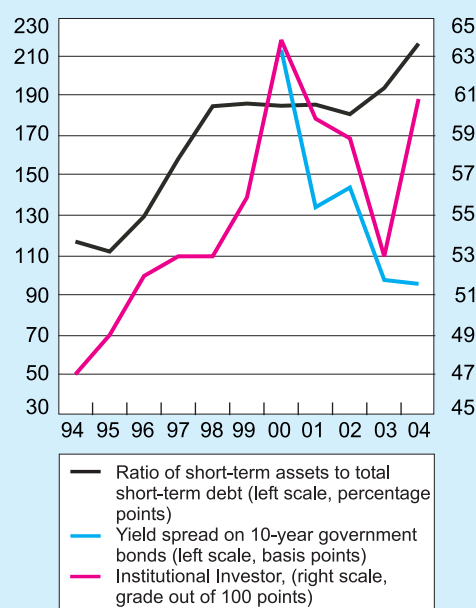
The rapid increase in external debt assets during 2004, relative to the growth of the external debt, brought the balance of net external debt to a negative \$ 12 billion—twice as large as a year earlier. Thus, the Israeli economy maintained its position as a net lender to the rest of the world.

The Israeli economy maintains a \$ 35 billion surplus of short-term debt assets—a positive indicator for nonresidents who assess Israel's country risk.

short-term external debt climbed to 90 percent. The share of short-term debt in total gross debt declined to 40 percent at the end of 2004 (Table 1.4.5). These data show that the economy is highly capable of repaying short-term debt and provide nonresidents with a positive indicator in their analysis of Israel's country risk. In the longer term, this may have a favorable effect on the price of external borrowing.

Notably, several rating services raised their outlook on Israel during the year, possibly signaling the chance of an improvement in country rating in the near future. However, the cost of raising capital, as measured in the credit spreads on long-term dollar-denominated government bonds, did not change substantially in 2004 (Table 1.4.5, Figure 1.4.3).

**Figure 1.4.3**  
Indices of Israel's Credit Risk,  
1994–2004 (end-of-year)



SOURCE: Based on data of the Accountant General, banks and companies.

**Table 1.4.5**  
External Debt Indicators, 1994–2004

	(end period, percent)										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
External debt ratios											
Gross debt/GDP	58	56	53	55	63	60	55	60	65	62	60
Assets/GDP	34	33	33	40	53	53	52	60	67	67	70
Net debt/GDP	24	24	19	15	9	7	3	-0	-2	-5	-10
Short-term <sup>a</sup> debt/gross debt	44	46	43	40	41	41	42	43	44	42	40
Short-term <sup>a</sup> assets/total assets	88	88	89	88	89	87	84	80	78	76	76
Short-term <sup>a</sup> assets/short-term debt	118	112	130	160	186	188	187	187	182	196	218
Reserves/short-term <sup>a</sup> debt	35	38	53	91	94	88	85	83	79	86	89
Credit rating											
Standard & Poor's	BBB+	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-
Moody's	A3	A3	A3	A3	A3	A3	A2	A2	A2	A2	A2
Fitch	BBB+	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-
Institutional Investor <sup>b</sup>	47	49	52	53	53	56	64	60	59	53	61
Euromoney <sup>b</sup>	72	76	76	77	76	71	73	72	69	68	67
Israeli government negotiable 10 year dollar bond spreads above US Treasuries (basis points)											
							215	135	145	98	96

<sup>a</sup> Short-term: maturing (realizable) in up to one year.

<sup>b</sup> A grade out of 100 points (100 points = no risk).

SOURCE: Bank of Israel, Central Bureau of Statistics, rating agencies, journals mentioned and Salomon Smith Barney.