



Section A

Introduction





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We are pleased to present the fifth and sixth annual reports of the Government Debt Management Unit in the Accountant General Division. This report refers to the years 2006 and 2007, during which a comprehensive reform in the government bond market was completed and implemented.

2006 was an additional year of continued positive trends in the Israeli economy, in the domestic capital market, and in the government-bond market, despite and in contrast to the severe political and defense-related events that occurred in Israel during the year.

There was no inflation in 2006, further to the trend of the preceding years; the consumer price index decreased by 0.1%. The Bank of Israel interest rate remained unchanged at 4.5%; the shekel appreciated from NIS 4.60 per dollar at the beginning of the year to NIS 4.22 per dollar by the end of the year; and the government ended the year with a far smaller deficit than expected, at about 1% of GDP, despite the unexpected expenses caused by the Second Lebanon War.

The boom continued in the capital market as well, for the fourth consecutive year. The TA-100 stock index rose by 11%; trading volumes grew, both in shares and in bonds; and foreign investors' involvement strengthened, in shares, as foreign investments reached a record level of USD 14.3 billion, as well as in bonds, as described below.

The effect of the three major reforms initiated by the Finance Ministry in previous years became more strongly apparent in 2006:

Tax reform – An additional stage of the taxation reform, started in 2003, was implemented. The equalization of taxation of investments in Israel and overseas and a certain increase in taxation rates at the beginning of the year did not cause shocks to the capital market, as some had feared.


Pension reform – As a result of the pension reform, in which the issuance of nontradable bonds to pension funds ceased almost entirely, about NIS 1 billion received by pension funds for the redemption of nontradable bonds are injected into the tradable capital market each month.

Capital-market reform – The sale of the majority of mutual and provident funds by banks to insurance companies and foreign investors was agreed upon and/or completed, as required by the recommendations of the Bachar Committee, which were published and approved in 2005.

2007 too was a very good year for the Israeli economy, for the local capital market, and for the government-bond market. The year can be roughly divided into two parts:

1. The first half of the year was marked by small amounts of funding (just NIS 5.7 billion issued in the tradable domestic segment during this period), reduction of the Bank of Israel interest rate, a significant decrease of the yield curve, and narrowing of spreads between Israeli and American government bonds.
2. The second half of the year fell under the shadow of the subprime crisis and its ramifications, and was marked by rising yields, increased volatility, widening spreads, rising inflation, an increase of the Bank of Israel interest rate, and growth in issuances in the tradable domestic segment.

Inflation in Israel in 2007, as in many countries, was above the upper limit of the target range (the CPI rose by 3.4%). The Bank of Israel interest rate was lowered by 0.25% during the year, to 4.25%. The shekel appreciated from NIS 4.21 per dollar at the beginning of the year to NIS 3.85 per dollar by the end of the year. The government ended the year with a far smaller deficit than expected (about 0% of GDP), mainly due to the impressive growth in state revenues.



The boom continued for the fifth consecutive year in the capital market as well. The TA-100 stock index rose by 25%; trading volumes grew, both in shares and in bonds; and foreign investors' activity strengthened greatly, in shares as well as in bonds, as described below.

Another notable key theme in 2007 was the meteoric growth of the corporate-bond market, which drew new offerings at a volume of NIS 80 billion. The majority of the issues were performed during the first half of the year, when the low interest rates and the small volume of government funding enabled large (as well as small) companies to compete over investors, as an attractive option, though sometimes with underpriced risk. The expanding spreads in the second half of the year, the global liquidity crisis, the increased rate of government funding, and the increase in yields led to substantial deceleration of funding in the corporate segment.

2006 and 2007 were highly significant years in the area of government debt, as processes begun a decade ago matured and the comprehensive bond-market reform known as the "market-making reform" was put into practice. Within the reform:

- Eight foreign banks, seven local banks, and four TASE-member investment houses (19 in total) were appointed as Primary Dealers.
- A new bond-issuance system was launched, based on the international Bloomberg system, as well as a new trading system based on the international MTS system.
- A government-bond lending facility was established, serving Primary Dealers.
- The consolidation of all government-debt management functions under one roof was completed, with the transfer of responsibility for the issuance and management of government debt from the Bank of Israel to the Ministry of Finance, under the Debt Management Unit in the Accountant General Division. A computerized debt-management system was developed for that purpose, based on the government-wide Merkava system. This organizational change has made it possible to streamline and improve government-debt management and tighten the essential connection between front-office and back-office functions.
- New types of bonds were launched: Government Bond (Unlinked), replacing Shahr bonds, and Government Bond (Linked), replacing Galil bonds.
- New bonds with very long durations were launched: a 20-year unlinked bond and a 30-year linked bond.

Several positive trends were already apparent, in relation to the expectations and objectives set for the reform, in the early months following its application during the last quarter of 2006:


- **Liquidity** – One of the main objectives of the reform was to introduce liquidity into the government-bond market. In fact, as a result of the reform, turnovers increased by hundreds of percent, reaching a daily record level of more than NIS 12 billion on certain days in the first half of 2007. The average daily turnover in 2007 was more than NIS 3 billion, versus the overall daily trading volume of about NIS 1 billion on average in the bond market prior to the reform.
- **Reduced concentration in the primary and secondary markets** – In the first months of the reform, foreign banks' share of activity already reached 36 percent in both the primary market (issues) and the secondary market (trading) – in contrast to the situation before the reform, when a small number of local players concentrated 90 percent of primary-market activity.
- **Involvement of foreign banks and investors in the local bond market, in NIS** – In the first quarter of the reform, foreign investors – including entirely new investors who arrived in the wake of the foreign market makers – invested almost NIS 10 billion

in purchases of government bonds in the local market. Prior to the reform, foreign holdings in government bonds accounted for less than 1% of tradable bonds (less than NIS 2.5 billion), far lower than the prevalent rate in bond markets overseas and than the level in the Israeli equity market.

- **Extension of the yield curve** – The high demand for government bonds subsequent to the reform made it possible to extend the term to maturity of linked bonds by 50% (from 20 to 30 years), and the term to maturity of unlinked bonds by 100% (from 10 to 20 years), without paying a premium different from the customary level paid worldwide to investors for the risk involved in holding longer bonds.
- **Development and improvement of capabilities of local market makers** – As part of the preparations for the reform, Israeli market makers, banks, and brokers have developed dealing rooms in bonds and NIS interest rates, which were almost nonexistent prior to the reform. These preparations included organizational changes, the implementation of new technological systems, and improved risk-management capabilities.
- **Increased competitiveness of issues** – The increased competitiveness of issues, following the entry of large international entities and the system of commitments of Primary Dealers, has led to more competitive prices being set in most offerings on the primary market, in contrast to the situation prior to the reform. This change obviously generates savings for the government.
- **Reduced funding costs** – The increased competition in the primary market and the greater tradability and liquidity in the secondary market, along with the expansion of the investor base, have all led to reduced funding costs for the government.
- **New trading arenas** – In addition to the TASE, which has retained its status as the dominant arena for trading in government bonds, some trading volume has moved to MTS, while some is executed over the counter (OTC). The first half of the year was marked by growing turnovers on MTS; however, trading volumes in this system decreased in the second half.
- **Regulation** – As part of the preparations for the reform, a number of regulatory restrictions were lifted for banks and institutional players, in order to allow them to operate more efficiently in the new environment. In addition, new legislation was enacted to allow mutual funds to trade directly with Primary Dealers starting in January 2008.

In addition to the reform, other achievements in the area of government debt were attained in 2006 and 2007:

- **A sharp decrease in the ratio of government debt to GDP** – This ratio, which is the most important indicator of the state's burden of government debt, decreased by 9% in 2006, reaching 85% by the end of the year. An additional 6% decrease in 2007 brought the government debt to GDP ratio to 79%.
- **Reduction of nominal debt** – In 2006, for the first time since 2000, government debt decreased in absolute terms (from NIS 553 billion to NIS 538 billion), rather than just relative to the GDP. This resulted from negative net funding – i.e., a surplus of redemptions over funding – of NIS 7.1 billion (1.1% of GDP) in 2006. This trend continued in 2007 as well, with the debt falling to NIS 524 billion, following negative net funding of NIS 11 billion, mainly due to an increase in state tax revenues and high proceeds of privatization, as well as the continued weakening of the dollar against the shekel.
- **Increase in tradable debt and decrease in nontradable debt** – The tradable component of domestic debt grew to 64% of domestic debt in 2006, while the nontradable component narrowed to 36% of domestic debt. An additional improvement occurred in 2007, as the tradable component reached 65% of domestic debt and the nontradable component decreased to 35%.

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- **Substantial increase in activity and holdings of pension funds in the tradable market** – Following the continued implementation of the pension-fund reform, these funds increased their holdings of tradable government bonds to 9% of the tradable market, compared with less than 1% prior to the implementation of the reform.
 - **Renewed issuance of short-term unlinked bonds** – Unlinked bonds with a term to maturity of two years were issued for the first time in several years in 2006. This trend strengthened in 2007, with the issuance of short-term government bonds with a term to maturity of a few months.
 - **Redemption of large series** – In 2006 and 2007, unlinked series with volumes of NIS 10-20 billion each matured without causing exceptional shocks or surplus supplies.
 - **Continued multi-year trend of decreasing number and growing volume of tradable bonds** – At the end of 2006, 52 bonds with an average volume of NIS 4.5 billion per series were traded; at the end of 2007, 46 bonds were traded, with an average volume of NIS 5.5 billion per series.
 - **Financial Assets Law** – A new law was enacted regularizing trade in repo contracts, swaps, derivatives, and additional financial instruments with a future component. The law regularizes the legal infrastructure allowing financial institutions in Israel to use prevalent international agreements, such as ISDA and ISMA agreements.
 - **Launch of new tools and instruments** – As part of the efforts to improve the efficiency of the government's cash-flow management and increase the effectiveness of debt-management policy, the Unit has started to operate swap auctions and issue short-term government bonds:
 1. Swap auctions – Starting in August 2007, swap auctions of substantial volume have been held each month (except in December). The swap auctions allow smoothing of the government's financing needs, streamlining of cash-flow management, and the exchange of nontradable series for new series ("on the run"). The use of swap auctions is expected to continue in the coming years as well, as a complement to issuance. In 2008, the Unit plans to begin operating reverse auctions in which the government buys government bonds for cash.
 2. Issuance of short-term bonds – Short-term bonds were issued for the first time in 2007, and are mainly used as a cash flow management tool. In cooperation with the Bank of Israel, which issues short-term notes (Makams), it was agreed that short-term government bonds would be issued for periods of 2-4 months. These bonds were issued at a volume of NIS 4.4 billion in 2007.
 - **Development of repo market** – During the year, a collaborative effort of the various regulators, the Tel Aviv Stock Exchange, and the banking system was initiated for the development of the repo market in Israel. This joint endeavor should mature in 2008. The government has signed its first framework agreement (GMRA) with a foreign market maker for repo transactions, and is expected to sign agreements with additional operators during 2008.

Developments in external debt:

- **Global offering** – In 2006, a global offering with a period of ten years, at a volume of USD 1 billion, was performed at a relatively low spread of 98 basis points (0.98%) over U.S. government bonds and 45 basis points over the LIBOR interest rate. In view of the crisis in the international markets, the euro offering planned for the early second half of 2007 was not performed. This offering will likely be carried out in 2008, provided that market conditions allow the government to issue the bonds with attractive spreads.
- **Innovative offering in Brazilian currency** – In 2006, an innovative private placement was performed at a volume of USD 0.5 billion, denominated in Brazilian real. The offering

was integrated with currency hedge contracts to create an exceptionally low NIS interest rate for the government, below the cost of funding in NIS for the government in Israel.

- **Israel's rating outlook upgraded** – After the three leading international rating agencies released positive reviews of the Israeli economy and raised Israel's rating outlook from Stable to Positive in 2006, the rating agency S&P upgraded Israel's rating to A in late 2007, while maintaining its Positive outlook. The other agencies are expected to reach decisions regarding Israel's credit rating in early 2008².
- **No bonds issued with U.S. government guarantees** – In 2006 and 2007, as in 2005, the government did not need to use the guarantees provided by the U.S. government in 2003. The guarantees were extended until the end of 2011, allowing Israel to raise an additional USD 3.8 billion with full backing of the U.S. government for both principal repayments and interest payments.
- **Execution of swap transactions** – A strategy of diversification of foreign-currency risks in government debt was initiated in 2007. In order to increase diversification, dollar-denominated debt was converted into euro-denominated debt in three swap transactions, at a total amount of USD 750 million.

This report covers all activity performed by the Debt Unit in 2006-2007 and provides a detailed description of the debt position. Section B reviews the government's cash-flow policy, and its issues on the primary market in terms of both quantity and funding costs; this section also contains a review of Israel's credit rating. Section C details developments in the secondary market, turnovers, and yield curves on the TASE. Section D presents details of the existing debt position in various breakdowns, and addresses the various risk indices of the debt. Section E presents a summary of the market-making reform.

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1 In early 2008, the rating agency Fitch upgraded Israel's credit rating to A and Moody's to A1.