

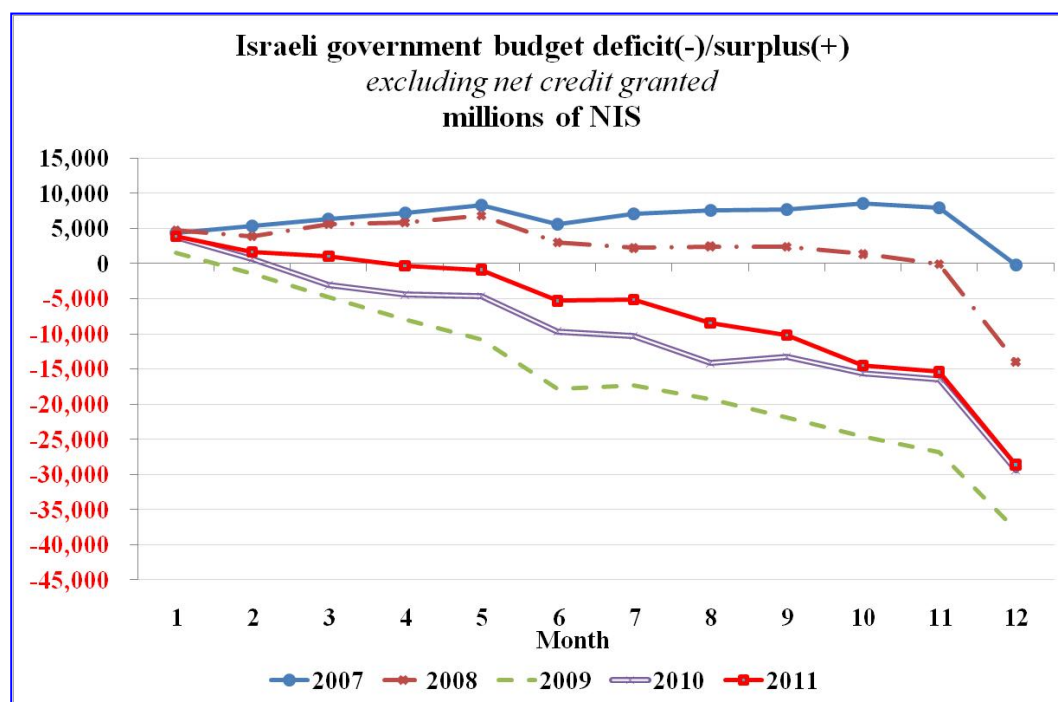
# Leumi Economic Weekly

January 11, 2012

**The government deficit amounted to NIS 28.6bn in 2011, equal to 3.3% of GDP**

The government deficit, excluding net credit granted, in 2011 amounted to NIS 28.6bn, similar to the overall deficit in 2010. The deficit as a percentage of GDP equaled 3.3% (based on the Central Bureau of Statistics estimate of annual GDP).

The 2011 deficit target was set at NIS 25.2bn, and thus the actual deficit of NIS 28.6bn represents a deviation of 0.4% of GDP. This deviation from the deficit target is attributed to state revenues from taxes, which came in below forecast, whereas expenditure performance stood at 99%, similar to the performance rate in preceding years. Total revenues from taxes increased nominally by 7.9%, compared to the budget plan, which called for a 10% increase. On the expenditure side, a 5.6% nominal increase was registered, which was below the original budget plan (7.4%).



Financing the budget deficit (including net credit granted) in the amount of NIS 23bn was based on the following sources of finance: proceeds from the sale of government owned land and privatization that amounted in 2011 to NIS 7.1bn (of this 65% from land sales), compared to the budget plan of NIS 3.8bn, net capital raising by means of bond issues in the local market in the amount of NIS 12bn; and government money withdrawals from its deposits at the Bank of Israel (BoI), which had accumulated over preceding years, in the amount of NIS 4bn. The net government capital raisings in overseas markets was near zero.

It appears this composition of deficit financing reflects a number of factors, among them being: the strength of the residential real estate market, which led to a high demand for land on one side, and on the other side the desire of the government to increase the supply of residential construction; and this was in addition to the problematic state of the capital markets in the developed markets.

Looking forward, we estimate the net fundraising needs of the government in 2012 will be higher than the budget framework calls for, by NIS 12-15bn, and will reach NIS 30bn, or more. Furthermore, it appears the amount of budget deficit financing expected for 2012 that will be directed to the local bond market will increase by a substantial degree, this due to a decline in alternative financing sources, and in particular, potential marketing of state lands. In terms of gross capital raising, which includes the recycling of government debt, that will come to redemption in 2012, and the financing of the deficit that will accumulate throughout the year, capital raising in the local market will amount to NIS 90-100bn. This compared to gross capital raisings in the amount of NIS 86bn in 2011.

As a consequence, the capital raising requirements of the government is likely to crowd out the capital raising needs of the business sector. This in turn is likely to make it more difficult for the recycling of the large amount of debt that stands to be redeemed in 2012. It must be added that in a long-term outlook, the credit raising requirements of the government are expected to remain relatively high. Thus for example, in a scenario created recently by the BoI of the government deficit through 2020, the current government deficit is expected to reach 3.5% of GDP each year through 2020. This is under the assumption of 3.5% average GDP growth per year, and no change in the tax rates. Looking at the government financing, we note the amount of government debt that stands to be recycled in the short-term will be relatively high, such that the gross fundraising sources of the government will be high in the coming years.

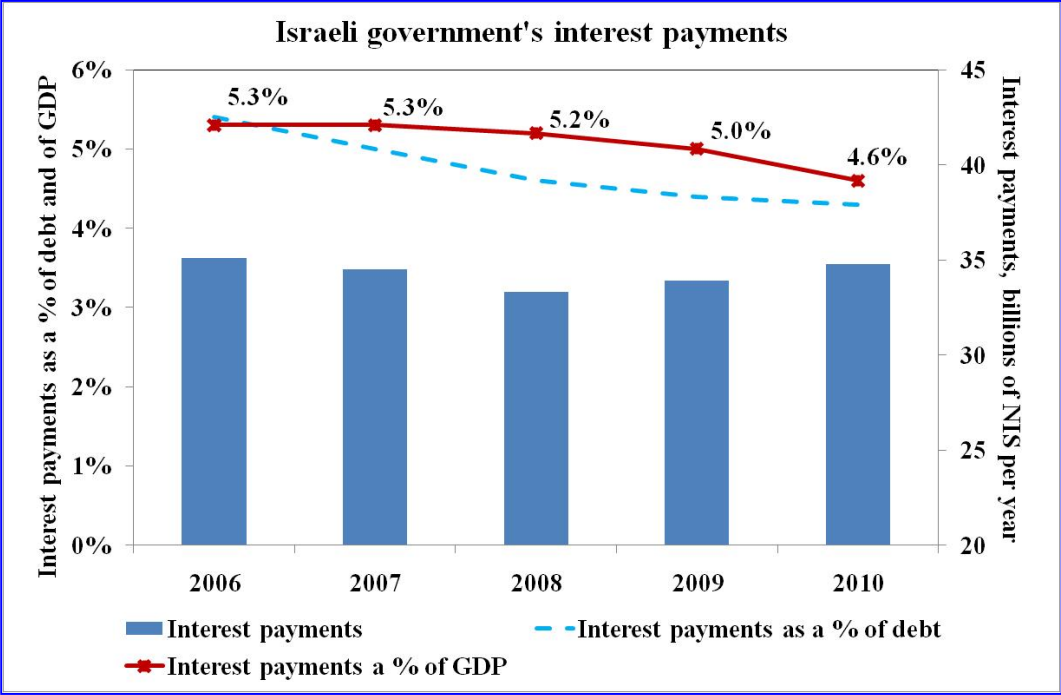
***The government issued 30-year non-linked shekel bonds, for the first time, as part of a policy to extend the government debt***

This week the government of Israel issued, for the first time, shekel denominated bonds for 30 years. By doing this, Israel joined the “club” of only 40 countries around the world that issue bonds of this duration. The total nominal value of the bond issue equaled NIS 200m, with a yield-to-maturity of 5.5%. The results of this bond issue reflect 2.6% inflation expectations for the long-term, thus expressing the confidence institutional investors have in the policies of the BoI to maintain price stability over the long-term. This is also reflected in the continuing rise in the proportion of shekel debt.

Demand for these 30-year bonds was very high, being 5.7 times greater than the actual amount offered. This indicates the need in the market for just such an instrument, especially for long-term pension savings institutions. This instrument is important for the stability of yields in the public’s pension savings, in particular against the backdrop of the cessation of the issue of government designated bonds for pension institutions, which was decided in 2003 (the final redemption of debt raised through government designated bonds to the veteran pension funds is expected to be completed in 2026).

The demand for the 30-year Israel government bonds supports the strategic policy decision, to extend the average duration of government debt, and to reduce the risk involved in debt

recycling. Further to the above mentioned, the current composition of debt indicates high fundraising needs in the short-term for the purpose of recycling older government debt that is reaching redemption, this being in addition to net capital raisings for the purpose of funding the deficit in the current year. What this means is that during the coming years the fundraising needs of the government will capture a large portion of the local capital market, thus threatening the amount of resources available for the business sector.



Extending the duration of government debt, from the level of 7.2 years at which it stood in 2010, and spreading the debt burden over a larger number of years, is important in a long-term outlook for balancing the fundraising needs of the government vis-à-vis the needs of the business sector. Squeezing the fundraising needs of the business sector over the course of time will reduce the amount of real investment in the economy, such as for example production capital, the importance of which to economic growth is significant. Of course, extending the duration of government debt is dependent to a high degree on the manner in which the financial markets will judge how well government policy is doing at meeting desirable targets, and in particular staying within the deficit framework and reducing the debt / GDP ratio, which stands today at about 73%.

As can be seen in the above shown diagram, in recent years there has been a moderate downward trend in the interest rate payments paid on government debt, in relation to the level of debt. The decline in the yield-to-maturity rates on government bonds in the markets contributed to this trend. Further to the above mentioned, maintaining affordable yield levels, while simultaneously extending the duration of the debt, is dependent on continuing to maintain responsible economic policy – monetary and fiscal. This means, among other things, upholding a conservative stance on the deficit path and the debt/GDP ratio, against the new constraints created in the socio-economic and global-economic environment, and maintaining price stability.

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