

**STATE OF ISRAEL
MINISTRY OF FINANCE
ACCOUNTANT GENERAL**

GOVERNMENT DEBT MANAGEMENT UNIT

ANNUAL REPORT - 2003

2



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Introduction

We are pleased to present the second annual report of the Government Debt Management Unit in the Accountant General Division.

The volume of Government debt increased in 2003, reaching NIS 520 billion¹, equal to approximately 105% of the gross domestic product of the State of Israel. The Unit's annual activity also reached record levels in 2003: an approximate NIS 50 billion in roll-over of principal, NIS 30 billion in interest payments, and NIS 28 billion in deficit financing.

A dramatic upturn occurred in the capital market during 2003. Following two months of high uncertainty and record-level bond yields (similar to the second half of 2002), a strong recovery took place in March, leading to sharp price gains in all capital markets, particularly in government bonds. 'Shahar' bonds, which had traded at yields of 12% and more in the beginning of the year, were trading at around 7% in July, generating capital gains of dozens of percentage points for investors. Foreign investors who purchased the bonds recorded still greater capital gains, in dollar terms, due to the exchange rate differentials resulting from the sharp appreciation of the Israeli shekel, which traded at NIS 4.9 per dollar at the beginning of the year, but fell to NIS 4.3 per dollar by July.

The dramatic trend reversal in the capital market stemmed from several causes, including the improvement in the geo-political situation resulting from the rapid conclusion of the war in Iraq, the improvement in the global economy, particularly in the high tech sector, and the credibility enjoyed by the new government's economic and budget policy.

Another factor favorably influencing the domestic capital market was the loan guarantees granted by the United States Government to the Israeli Government. This program, at a volume of approximately \$9 billion, enables Israel to borrow money on the global capital market, for periods of 20 and 30 years, at interest rates close to those at which the U.S. Government raises capital – significantly lower rates than the Israeli Government could obtain without the guarantees. The benefits of the guarantees far exceed the financing itself, in that they help to rapidly reduce the yields at which the Government raises capital, not only abroad, but on the domestic market as well. The Debt Management Unit was one of the initiators of the program and has been involved every step of the way, and will continue to make use of the guarantees in the coming years as well.

In 2003, the Debt Management Unit continued its long-term trend of rapidly reducing the number of series traded, while sharply increasing their volume. This year, Government bonds, particularly 'Shahar' bonds, again continued to be the most tradable instruments on the stock exchange, while non-linked bonds accounted for the majority of tradable Government debt for the first time. It should be noted that up until 1992, there were no non-linked bonds in Israel at all, and the first 'Shahar' bonds were issued in 1995.

¹ Data in this report is updated as of August 31, 2004.



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In 2003, the Unit continued to promote the reform in the bonds market, centered on the appointment of primary dealers, who will contribute to the enhanced sophistication of the bonds market, enable foreign banks to take an active and committed role in the Israeli capital market, and reduce the cost of raising capital for the Government. Interest payments, which amount to some NIS 35 billion each year, comprise a significant portion of the Government budget; this component has yet to receive in-depth treatment. The proposed reform is expected to save over NIS 1 billion annually in interest payments, thereby helping to reduce the burden of public expenditure in the GDP – an essential process in order to reduce the tax burden and release resources to the private sector.

In addition, the reform complements the capital market reform published in November 2004 by the Bachar Committee, headed by the Director-General of the Ministry of Finance, which addresses the desired structure of the capital market, and the relationship and ownership ties between the banking system and asset managing entities in Israel.

As part of the strategic effort to draw foreign investors to the Israeli capital market, the Government Debt Management Unit, in collaboration with the Tax Authority, initiated a full exemption to foreign investors on capital gains and on interest payments for holdings of Government bonds. The full exemption was approved in September 2004, but applies retroactively from the beginning of the year. It is hoped that the approval of the exemption, which is customary worldwide, will encourage foreign investors who have hitherto avoided investments in Israeli Government bonds.

In April 2003, several improvements were introduced in bond auctions, making the minimum price, which is no longer published, more effective, and allowing over-allotments ("greenshoe") at the closing price of tenders, resulting in a more flexible supply of bonds than in the past. The change has been successful from the outset, as full over-allotments are performed in a large number of tenders.

In 2003, two additional reforms with highly significant impacts on the bonds market took effect. The reform in pensions is expected to bring pension funds into the tradable Government bonds market, whereas hitherto they have been almost totally absent from this market, mainly purchasing nontradable bonds. The participation of the pension funds, which are natural clients of the tradable capital market in general, and the Government bonds market in particular, will contribute greatly to improved liquidity, tradability, and depth in the market. The tax reform, whose implementation began in 2003, will also significantly influence the nature and volume of trading by various investors in the capital market in general, and in the Government bonds market in particular.

* * *

Section A will describe the major guidelines of the Government's debt management policy – the main goals and considerations in the management of Government debt, the risk management system, other policy tools, and the Government's means of raising capital in Israel and abroad.

Section B will describe the macro-economic developments in 2003, and the main trends in the Government bonds market, in Israel and abroad.

Section C will detail the main developments in overall Government debt, domestic debt (tradable and non-tradable), and external debt. In addition, this Section will describe the Government deficit and the ways of financing it: tradable and non-tradable funding in the domestic market, funding by the Government in international capital markets, and funding through the Bonds organization.

Section D will describe the highlights of the reform in the Government bonds market approved by the Israeli Government in July 2004, which is centered on the introduction of primary dealers.

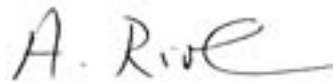
Section E will survey the change in the tender method in issues of Government bonds, and developments in Israel's credit rating. Section F will examine the effects of the reform in pension funds on the bonds market, as well as the influence of the tax reform which took effect on January 1, 2003.

Yuval Bronstein



Deputy Accountant General

Adi Rivlin



Head of Government Debt Management

Part A

Debt Management Unit, Debt Management Policy Goals, and Tools for Implementation

1. Debt Management Unit – Structure and Functions

The Government Debt Management Unit is responsible for the management of domestic debt and external debt, and for the development of a model for overall debt management. The Unit is responsible for issuing tradable bonds on the domestic market and abroad; managing the tradable and non-tradable domestic debt; initiating and promoting structural changes in the domestic capital market, and, in particular, enhancing the sophistication of the secondary bonds market; studying and monitoring the condition of international markets; and maintaining contacts with international credit rating companies and working relationships with the Development Corporation for Israel ("Bonds Organization").

The Unit was established in January 2002, when the Foreign Currency Transactions Department in the Accountant General Division was merged with part of the Capital Market Department in the Capital Market, Insurance, and Savings Division. Until the Unit was established, the Foreign Currency Transactions Department was responsible for managing external debt, while the Capital Market Department managed domestic debt. The decision to combine both departments into a single unit within the Accountant General Division was aimed at improving the efficiency of Government debt management. The establishment of the Debt Management Unit within the Accountant General Division, which is responsible for the execution of the State budget, uniting all the professional functions and the extensive knowledge accumulated under one roof, has led to better coordination between all the relevant elements, and to higher quality management of Government debt. The establishment of the Unit was based on successful experience in various countries, as well as the recommendations of the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD).

The Debt Management Unit is composed of three departments, according to its main areas of activity: the Domestic Debt Management Department, the External Debt Management and Foreign Currency Transactions Department, and the Risk Management Department.

A. Domestic Debt Management Department

The Domestic Debt Management Department is responsible for issuing Israeli Government bonds on the domestic market, managing the tradable domestic debt (determining instruments for funding, debt redemption period, and linkage type), handling non-tradable domestic debt, managing activities with the Bank of Israel (which is responsible for recording, clearing, and payments for the debt (back office)), carrying out measures to increase the tradability and liquidity of Government bonds (purchase tenders, reductions in the number of series, and increases in their volume), and enhancing the sophistication of the domestic bonds market, including the initiation of structural changes in the capital market (such as the introduction of primary dealers into the Israeli Government bonds market).

B. External Debt Management and Foreign Currency Transactions Department

The External Debt Management and Foreign Currency Transactions Department is responsible for performing issues abroad (selecting target markets, timing of issues, and volumes; locating underwriters; and preparing legal and marketing materials), maintaining relationships with international credit rating agencies, monitoring international markets and studying new markets, handling civilian aid from the United States, and additional matters related to the Government's foreign currency transactions. In addition, the Department serves as a liaison for the Ministry of Finance Representative Office in New York.

C. Risk Management Department

The Risk Management Department is responsible for assessing the risks related to debt management, identifying courses of action to reduce the costs of debt, and pricing specific Ministry of Finance transactions.

2. Government Debt Management Policy

D. Main Goals

1. Minimizing the cost of funding.

The most important goal of Government debt management is to provide the Government with stable financing at minimal cost, while taking risks into account. In order to minimize the cost of funding, the funding mix is determined by comparing the costs of raising capital in the different channels.

2. Increasing the tradability and liquidity of domestic debt

A bond holder's ability to sell the bonds easily, at a price close to the market price, at any given moment, depends on the volume of trade that generally characterizes the bond. Increasing the tradability and liquidity of bonds thus raises demand for them and reduces the Government's funding costs. Therefore, in recent years, the Ministry of Finance has reduced the number of series traded and expanded their volume (see details in Section C). In addition, the Government Debt Management Unit has begun a process aimed at introducing primary dealers into the Government bonds market (see details in Section D), whose entry is expected to greatly increase the liquidity and tradability of Government bonds.

3. Creating points of reference in domestic and foreign markets

Government bonds issued on the domestic market serve as points of reference for the different players, facilitate the pricing of corporate bonds, and encourage the development of the domestic bonds market. For this purpose, the introduction of primary dealers, and their commitment to quotes on the secondary market at a minimal amount of NIS 5 million, will provide indicative prices for the Government bonds market, and facilitate the pricing of corporate bonds.

The Ministry of Finance is also acting to create a non-linked (nominal) yields curve based on highly tradable bonds at various terms to maturity, a common practice in developed economies. The improvement in the structure of the curve is attained via issues of bonds at fixed terms to maturity (benchmarks), and issues of bonds at terms to maturity in which there are no non-linked tradable bonds.

The Ministry of Finance is acting to create points of reference in international markets through the issuance of Government bonds. The existence of tradable Israeli Government bonds in international markets assists in pricing additional Government issues, as well as issues by Israeli companies (issuers from the private sector). In this context, it should be emphasized that despite the inexpensive funding available to the State of Israel in the form of U.S. Government loan guarantees, the Debt Management Unit intends to continue to issue tradable bonds which are not backed by U.S. Government guarantees (hereafter: "unbacked bonds") on international markets.

E. Risks and Means of Handling Risk

1. Optimization of the debt structure

- Establishing the domestic debt mix and the funding mix derived from it – previously, domestic debt was almost entirely linked to the Consumer Price Index or to the dollar. However, in recent years, the Ministry of Finance has made efforts to enlarge the share of non-linked debt out of the overall tradable domestic debt, in order to attain a more balanced mix of Government debt. This has been achieved through increased funding in non-linked channels, subject to funding costs. At the end of 2003, the supply of non-linked tradable debt exceeded the supply of (dollar and CPI) linked tradable debt for the first time.
- Establishing the desired external funding mix – currently, most of the external debt is denominated in U.S. dollars. The Ministry of Finance is acting to diversify the currency mix of the debt status through issues in other currencies (such as the Euro, Japanese Yen, Canadian Dollar, and Pound Sterling), and to change the interest mix (fixed/floating) through floating-interest issues based on the LIBOR interest rate, both through the Bonds Organization and through other funding tools (bank syndications, private placements, and swap transactions on bond issues).

2. Reducing refinancing risks

Refinancing risk is the risk that the debt will need to be rolled over at particularly high cost due to inconvenient market conditions, or that it will be impossible to roll it over at all. The Debt Management Unit is working to reduce this risk by extending the term to maturity of domestic debt (subject to market conditions), and timing the maturity dates of new series to smooth the maturity curve. In addition, the Unit is acting to change the law in order to allow voluntary early redemption of Government bonds. This change will enable optimal 'smoothing' of the curve towards the original maturity date.

3. Investor relations

The Debt Management Unit's activities with financial entities and with financial rating agencies abroad provide added value and help to attract foreign investors.

4. The Government's credit rating

The Government Debt Management Unit maintains ongoing ties with credit rating agencies, in order to preserve (and, when possible, improve) the Government's credit rating. The Government's foreign credit ratings serve as a ceiling for the credit ratings of Israeli companies, and a downgrading would damage the funding capability abroad of the business sector and of the banking sector.

5. Increased transparency

Disclosure and transparency are highly important to the reduction of investors' sense of uncertainty. Increased transparency and reduced uncertainty will encourage additional investors to invest in the Government bonds market, and will lower the Government's funding costs. Therefore, the Debt Management Unit is acting to increase transparency in the bonds market. This activity includes advance publication of the monthly funding plan in Government bonds and quarterly volumes of funding, the publication of a comprehensive annual report in Hebrew and in English, and the operation of an Internet website in Hebrew and in English.

6. Maintaining foreign currency reserves

The volume of foreign currency reserves held by the Bank of Israel was approximately NIS 26 billion at the end of 2003. As a result of the loan guarantees plan and a positive net amount of capital raised, the volume of reserves is expected to rise in the coming years.

3. Funding in the Domestic Market

The main source of funding for the Israeli Government is the domestic capital market. Capital is raised through issues of tradable and non-tradable bonds denominated in shekels, for private and institutional investors.

F. Tradable Funding

Tradable funding is carried out through issues of bonds on the Tel Aviv Stock Exchange (TASE). The Government currently issues non-linked bonds at a fixed interest rate ('Shahar') and at a floating interest rate ('Gilon'), and CPI-linked bonds at a fixed interest rate ('Galil'). In the past, the Government issued other linked bonds, such as floating-interest, CPI-linked bonds ('Kfir') and floating-interest, dollar-linked bonds ('Gilboa'). However, since February 2000, the Government is no longer issuing these bonds. Redemption of the last large series of 'Gilboa' bonds took place in July 2004, and, with the exception of a negligible series at a volume of NIS 300 million, no 'Gilboa' bond series remain in circulation.

Despite the development of the corporate bonds market in recent years, Government bonds still comprise the main part of the tradable bonds market. Thus, the Government's funding policy impacts not only the cost of financing its deficit, but also the strength and behavior of the Israeli bonds market.

G. Non-Tradable Funding

Another source of financing for the Government is the issuance of non-tradable bonds at a guaranteed real interest rate ('designated' bonds) for pension funds and insurance firms. The remainder of non-tradable funding is comprised of deposits by various entities at the Ministry of Finance (called 'emissions'), based on agreements signed long ago.

Pension Funds

Under the investment regulations that were in effect until August 2003, new pension funds were required to invest some 30% of their net accrued funds in free investments on the capital market, while the balance was invested in 'Arad' nontradable bonds, which generated an effective annual yield of 5.05%. 'Old' pension funds were required to invest **at least** 93% of their members' money in 'Miron' nontradable bonds, which generated an effective annual yield of 5.57%. The 'old' pension funds, unlike the new funds, were permitted to enlarge their investments in Government bonds, without limit. Thus, during periods of low market yields, the rate of nontradable bonds in the 'old' pension funds' portfolios were expected to rise, and vice versa.

Following the reform in pension funds (see details in Section E), the rate of the nontradable bonds component out of the overall assets of pension funds will be lowered to only 30%. Therefore, issues of nontradable bonds will cease in the coming years, until the desired investment target is achieved. Once the proportion of nontradable bonds falls to 30%, issues of 'Arad' type nontradable bonds will be renewed, at an effective interest rate of only 4.86%, for both the 'old' and the 'new' funds.²

Insurance Firms

Under the agreement between the State and the Association of Life Insurance Firms and Insurance Firms, the State issues 'Chetz' nontradable bonds to insurance firms, against all or part of their obligations to clients under CPI-linked life insurance plans. The bonds are issued against policies sold through the end of 1990 only. For policies sold until January 1975, the coverage rate for the insured assurance is 100%. For policies sold from that time until the end of 1990, the issuance of 'Chetz' bonds is limited to 86% of the insurance coverage. The bonds are issued for periods of 10 to 25 years, and generate yields of 4% to 6.2%.

² 'Arad' bonds with a nominal interest rate of 4.8% paid an effective interest rate of 5.05% up until the implementation of the reform, due to their issue at a discount. Their issue at 100 ("par") will bring the effective interest rate down to 4.86%.

4. Funding Abroad

In addition to its domestic funding, the State of Israel raises capital in foreign currency on international markets. Funding is carried out abroad both directly by the Government, and through the Bonds Organization. Unlike in the domestic market, the external debt is denominated in foreign currency. The volume of the Government's foreign currency funding is determined by its foreign currency needs in order to finance its expenses abroad, by the need to roll over existing debt that reaches maturity, by the volume of foreign currency reserves required at the Bank of Israel, and by the size of the external debt and the ratio of the external debt to the GDP.

H. Main Sources of Funding Abroad

The Bonds Organization

The Bonds Organization (The Development Corporation for Israel) was founded in 1951, as an initiative of the Prime Minister at the time, the late David Ben-Gurion. The task set before the Organization was to encourage the purchase of Israel Independence Issue bonds, which the Israeli Knesset had resolved to issue in the previous year, by American Jews.

From that time to this day, the Bonds Organization has had two main goals:

1. Raising capital in foreign currency for the State of Israel – the Organization works to increase total sales as well as the number of purchasers of bonds, and to expand the geographic area within which the bonds are sold, through the operation of regional agencies that maintain ongoing ties with local communities. Additionally, the Organization contributes to the diversification of the Government's sources of foreign currency funding; this diversification is especially important during periods of unfavorable market conditions.

It should be emphasized that the primary goal of the Organization is to sell bonds to communities and individuals (mainly Jews) throughout the world. It therefore does not compete with the Israeli Government's funding on the international market, which is aimed primarily at foreign institutional investors.

2. Reinforcing relations with the Jewish Diaspora – strengthening ties between Jewish communities abroad and the State of Israel.

Some one million bond holders are currently registered in the Organization's books, owning amounts ranging from 100 to tens of millions of dollars. Today, purchasers of the bonds include Jews and non-Jews, sovereigns, provident funds, pension funds, labor unions, municipalities, and others. The State of Israel pays the interest as well as the principal. Since the organization was founded, over \$18 billion have been repaid to lenders, and no delays or arrears have ever been recorded in payments of either principal or interest. Beyond the sale of bonds, the Organization has a national significance that cannot be quantified in financial terms. An example is the Bonds Organization's involvement in bringing delegations of hundreds of investors from foreign

countries to Israel each year. Additionally, the Bonds Organization is involved in encouraging tourism, direct investments in Israel, and immigration of Jews to Israel.

Each year, the Accountant General Division at the Ministry of Finance determines the annual funding goal for the Bonds Organization, according to foreign currency needs and other strategic goals in the Government's external debt management. Once a month, the Accountant General Division determines the interest rate paid for the various securities. The interest rate is determined based on the required spread over the yields of U.S. Government bonds for the appropriate period, in order to attain the annual funding target at the lowest costs.

The Bonds Organization offers several different types of non-tradable bonds, which differ by a few main parameters: the type of interest (fixed/floating), the way in which the interest is calculated, the repayment period, the conditions for early redemption, the minimal purchase volume, and the restrictions that apply to the target audience (see details in Appendix D). An additional distinction, which is essentially technical, is that the funding tools for which the fiscal agent is the Bank of New York are called "bonds", while funding tools for which the fiscal agent is the Ministry of Finance Representative Office in New York are called "notes".

Independent Public Issues

In 1994, the Accountant General Division made a strategic decision to carry out public issues of bonds in the amount of \$200-250 million each year between 1995 and 1998, in one or more of the international financial markets. From 1995 to mid-2004, nine international issues were performed in the three central capital markets – the American market, the Euro market, and the Japanese market. The strategic decision to penetrate international markets was taken based on the economic development of the State of Israel, which enabled foreign currency funding through self-guaranteed issues, i.e., without external guarantees. Since 1999, the volume of issues has increased several times; in 2003, the Israeli Government issued bonds at a volume of \$750 million. The increased volume of the issue contributed to the enhanced liquidity and tradability of Israeli Government securities, and to added depth in the Government's issuance infrastructure. In 2004, the Government performed an additional issue at a volume of \$500 million, for a period of ten years. The issue was carried out at a spread of 115 basis points (1.15%) over U.S. Government yields, the lowest spread achieved by Israel for a comparable issue since 1995, and some 40 basis points lower than the previous issue.

Independent issues have the following advantages:

- Reducing dependence on foreign governments, and preparing an infrastructure for economic independence.
- Creating an additional source for raising capital in foreign currency, which increases flexibility in selecting funding sources.
- Opening new financial markets to the Israeli economy.
- Exposing the Israeli economy to foreign investors – a 'road show' is performed as part of the issuance process. Additional means are also used during capital raising, such as advertising

and public relations. These methods expose the Israeli economy to foreign investors, making the name 'Israel' a brand name in the field of credit.

- Creating a benchmark for issues of Israeli companies abroad.

Israeli Government bonds are priced above the local benchmark in each of the international markets (TB in the American market, Bund/OAT in the Euro market, and JGB in the Japanese market). However, quotes for Israeli Government bonds are not available for all markets and for all possible terms to maturity. There are several methods for estimating the missing spreads:

- Determining the Israeli Government's spread based on the spread of a reference ('peer') group. This group is the group of countries with a credit rating similar to Israel's, whose bonds are similarly priced in the market (South Korea, Poland, Croatia, Chile).
- Determining the spread using quotes of the Israeli Government's spread for different terms to maturity or in other markets. This quote is translated into the desired theoretical quote via exchange quotes between currencies, interest rates, and markets.
- Determining the spread using the spreads of Israeli utility companies.

Public Issues Backed by U.S. Government Guarantees

In May 2003, the U.S. Congress approved a grant of guarantees to the Israeli Government for the purpose of raising capital abroad, in the amount of \$9 billion, for three years. Bonds issued by the Israeli Government backed by U.S. Government guarantees enjoy a credit rating similar to that of the U.S. Government; in fact, the bonds are sold at a yield that is slightly higher than the yield of U.S. Government bonds. However, a commission for the guarantee is paid out of the proceeds of the issue to the Federal Agency for International Development (A.I.D.), which sponsors the bond issues. According to the original plan, Israel should have raised a total amount (before deductions) of \$3 billion annually. However, unused sums could be carried over from year to year. These conditions, along with the extension of the plan, provide the Government with a flexible, inexpensive channel for funding. In this connection, it should be emphasized that despite the inexpensive funding available to the State of Israel in the form of U.S. Government guarantees, the Debt Management Unit does not intend to stop issuing bonds that are not backed by U.S. Government guarantees ("unbacked bonds") on international markets.

Private Placements

Private placements are a complementary funding instrument to the conventional instruments. Unlike public issues, whose price is quoted on the various markets, and which are traded on the secondary market, private placements are traded OTC (if at all).

A private placement is an engagement between an investor and a major borrower, mediated by an investment bank. Since private placements have no regulated secondary market, and the engagement to perform the transaction is carried out based on market opportunities, the contact between the parties is formed at the initiative of a mediating bank that is aware of the needs of both parties and arranges the transaction.

Private placements have several advantages, including the following:

- Relatively low issuance costs.
- Strengthening Israel's status in the international markets, and improving credit pricing in the long term.
- Exposing the State of Israel to new institutional investors.
- Creating additional points of reference for the Israeli Government in the international markets through relatively small issues.

Bank Consortiums

In a bank consortium, foreign currency capital is raised directly from the banking system. An 'arranger' bank leads the consortium, and contacts foreign banks on behalf of the State of Israel. The bank is selected through a procedure similar to a tender. Prior to raising the capital, the Government determines the main parameters: the volume of capital to be raised, the type of currency, the term to maturity, and the maximal total cost of the issue.

Shelf Registrations

In the attempt to penetrate international markets, the Accountant General makes use of shelf registrations. These plans establish the legal infrastructure for issues in advance, thereby enabling issues on international markets to take place rapidly, with little effort. Shelf registrations are used for private placements, public issues, and bank consortiums.

Shelf registrations have the following advantages:

- Flexibility — the plan formulates a framework for the management of external debt: funding in various currencies, for different terms to maturity, at different types of interest (fixed, floating, zero coupon, and more), different types of structure (simple or structured), and different types of issues (public or private).
- Rapid execution of transactions — a single negotiation conducted with regard to the legal infrastructure of all the transactions within the plan allows for rapid execution of transactions.
- Quick response — the plan makes it possible to take advantage of market opportunities and raise capital according to banks' proposals (investor-driven issues).
- Provides the issuer with the option of determining the volume, type, and term to maturity of transactions, according to needs, while taking market conditions into consideration.
- Allows rapid funding in case of unexpected needs.
- Allows increases or decreases in the volume of the plan.

In 1996, at the initiative of the Accountant General, the State of Israel joined an EMTN (Euro Medium Term Notes) program. This program formulates a specified framework for the management of funding in the Euro market, and affords accessibility to the market and a more efficient issuance process. In addition, the Accountant General has opened shelf registrations for issues in the United States and Japan.

5. Risk Management

Examinations of the distribution of risks related to debt management, identification of measures to reduce the costs of debt, and analyses of the risks in the Government's liabilities portfolio are essential tools assisting the Government in meeting its financing needs and fulfilling its obligations at the minimal cost possible (in the medium and long term) while taking risk limitations into consideration.

There are various types of financial risks to be measured and managed. Some of these risks are difficult to quantify and measure (operating risk, for example); work and monitoring procedures need to be determined in order to minimize these risks.

- **Market risk** – risk derived from changes in market prices, such as changes in interest rates and exchange rates, changes in volatility, etc. In order to calculate risk indices such as VaR, it is first necessary to assess the market value of the portfolio and its sensitivity to changes in the relevant risk factors in the market.
Market risk factors include the zero curves for each relevant currency, exchange rates, standard deviations, correlations, and possible changes in spreads.
- **Rollover / refinancing risk** – the risk that debt will have to be rolled over at a particularly high cost due to inconvenient market conditions, or that there will be no possibility of rollover at all.
- **Liquidity risk** – there are two aspects to liquidity risk. On the buyer's side, the cost (the 'fine') required to exit a position when the depth and volume of the market are low (even temporarily); on the seller's side, difficulties may arise if it becomes necessary to raise money within a short timeframe.
- **Credit risk** – the risk that the debtor party will not fulfill its obligations; thus, this risk applies primarily to the assets side (for instance, in swap deals).
- **Additional risks** – in addition to the risks noted above, there are other risks that belong to the category of 'operating risk', including, among other things, technical malfunctions, computer system errors, embezzlement and similar occurrences, legal risk (which may also be seen as part of operating risk), and model risk, which is the risk that the models used or parameters of the models are inaccurate.³

The activity of the Risk Management Department (Middle Office) focuses on three main areas:

- Establishing and expanding the debt management framework;
- Pricing of deals;
- Assisting on various strategic matters.

³ It is important to emphasize that these risks are not independent.

■ Establishing and expanding the debt management framework

The debt management framework can be divided into two levels: strategic and tactical.

Debt policy is determined at the strategic level, while funding policy is determined at the tactical level.

Debt policy defines various parameters of the liabilities portfolio, and is based on medium and long-term considerations. Given the size of the debt, debt policy specifies the optimal currency mix and interest mix (fixed and floating), and the desirable duration of the debt, whereas funding policy specifies the channels in which debt should be raised, at a given moment.

The debt manager's goal is to identify the liabilities portfolio that will generate minimal costs at a given risk level (or vice versa), taking into consideration the economic and budgetary costs and risks. The separation of economic cost and budget (accounting) cost is due to the fact that interest repayments on the debt (unlike repayments of principal) impact the deficit in the State budget.

The separation principle — the decision which new debt should be issued can be separated from the decision as to the optimal mix. The separation principle applies when the issuer is a minor player in the market (a 'price taker'), and when there are financial instruments in the market that enable an exchange of risks. For example, it is possible to raise bonds denominated in dollars, and then convert the dollar liability into a Euro liability via a currency exchange transaction.

Since the Government is the key player in the domestic foreign currency market, the separation principle does not apply with regard to domestic debt; thus, strategic and tactical considerations must be integrated in this market.

The benchmark model

Since we manage the liabilities portfolio only (without the assets side), no position is risk-free. In order to fill the void thereby created, a benchmark must be defined, to serve as a risk-free position. The benchmark serves as an indicator of the point (range) for which the debt manager should aim.

The model is an optimization model based on simulations, and among other things, generates efficient cost/risk curves, enabling decision makers to determine optimal mixes, according to their risk preferences.

When the model is run, thousands of possible courses for the risk factors are sampled. For each course, different cost and risk measures are calculated.

The model has hitherto focused primarily on external debt. In the coming years, we intend to expand it to domestic debt as well.



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Testing the sensitivity of interest and principal payments to market factors

The Risk Management Department routinely examines the sensitivity of interest and principal payments to the various risk factors, and their influence on the State budget. The result of the sensitivity report is the **distribution** of payments, not a sensitivity analysis of 'what if' scenarios. In other words, in addition to the expected payment as a result of the occurrence of a certain event, the probability of its occurrence is also calculated.

This report is also joined by the extreme situations (stress testing) report, which describes the effect of extreme situations on the expected cash flow. The purpose of these reports is to contribute to discussions about the deficit and means of financing it, and to help determine the required safety margin for budgeting interest and principal repayments.

■ **Pricing**

During this year, the Risk Management Department has developed in-house pricing capabilities of various sophisticated financial instruments, such as callable bonds, basis swaps, FX swaps, IR swaps, and more.

■ **Assistance on various strategic matters**

In 2003, the Department assisted in additional areas, such as promoting the introduction of primary and secondary dealers into the Government bonds market, examining the risks of various State guarantees, publishing future debt repayment forecasts, and more.

Part B

Developments in the Domestic Government Bonds Market and in the Global Bonds Markets in 2003

1. Macro-Economic Developments and Developments in the Domestic Capital Market in 2003

At the beginning of 2003, the Israeli economy was in recession for the third consecutive year. The gross domestic product (GDP) increased by only 1.3% during the year, and per capita GDP declined by 0.5%. 2003 was also characterized by negative inflation (-1.9%), as well as a decrease in the exchange rates of the dollar (7.6%) and of the currency basket (1.6%). Like in 2001 and 2002, State revenues from taxes declined in 2003, due to the slowdown in economic activity; despite the 1% reduction in public expenditures, the deficit in the State budget was significantly greater than planned, amounting to 5.6% of the GDP.

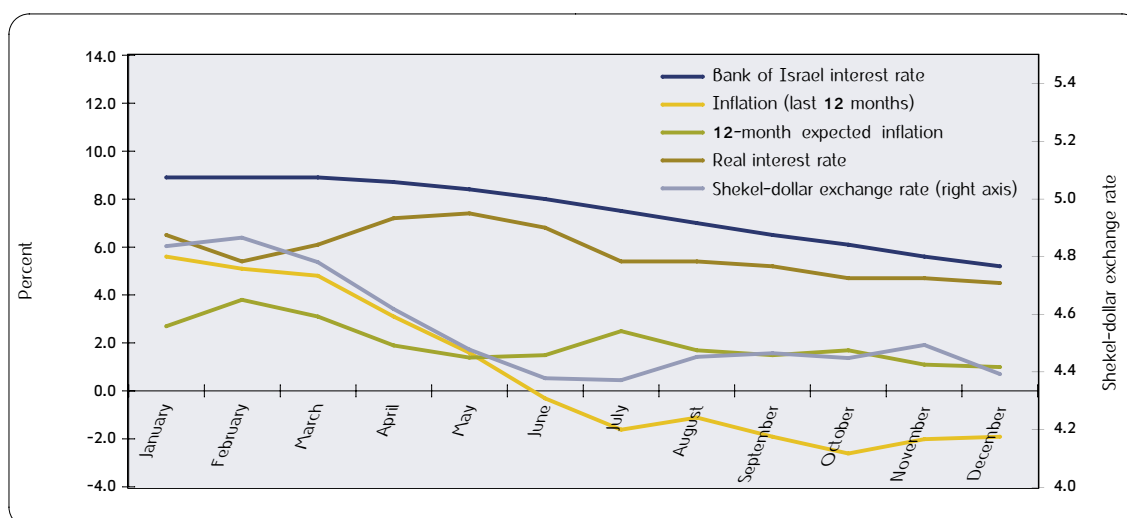
In light of the deviation from the original target deficit, which was already evident in the first few months of the year, the Government initiated a series of measures in March, in order to reduce the deficit and carry out structural reforms, of which the most notable was the reform in pension funds. This reform includes the cessation of issues of non-tradable designated bonds to pension funds, and their entry into the capital market as an important, active player.

The measures taken by the government and the convergence of the expected inflation rate towards the Government's long-term inflation target range (even dropping below it in the short term) enabled the Bank of Israel to lower the nominal interest rate from 9.1% in December 2002 to 5.2% in December 2003. However, the decrease in real interest was far more moderate, due to the decline in expected and actual inflation (see diagram).

As a result of the measures implemented by the Government, the reduction in the interest rate, and the favorable developments in global markets, encouraging signs increasingly began to appear during 2003, indicating an emergence from recession of important economic sectors: during the year, exports of goods and services grew by 6.1%, the business product increased by 1.8%, private consumption increased by 1.7%, and the decline in per capita private consumption was almost completely halted. In addition, an examination of the growth rates in the second half of the year reveals an acceleration in growth, to 1.7% in annual terms (seasonally adjusted).

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Diagram B-1: Developments of interest rates, exchange rates and inflationary expectations in 2003



Sources: Economic Division — Ministry of Finance, Bank of Israel.

Subsequent to the economic improvements, sharp price gains were recorded in the capital market, beginning in March. The TA-100 Index and the TA-25 ('Maof') Index rose by 60.7% and 51.0%, respectively, during the year. The domestic capital market enjoyed renewed interest, with the average daily turnover in equities and convertible securities rising by 52%, to NIS 332 million. The bonds market benefited from a sharp drop in yields, allowing a very large number of private companies and institutional investors to raise capital from the public through issues of corporate bonds. According to Bank of Israel data, the volume of capital raised via corporate bonds in the domestic market totaled an approximate NIS 17.8 billion, of which some NIS 11.6 billion were in non-tradable bonds.

The following four factors influenced the capital market in 2003:

- **Firm fiscal policy** — the measures taken to reduce government expenditures, at present and especially in the future, including the reform in pensions and the cutback in social benefits, led to increased confidence in the Government's policy in the domestic capital market as well as among foreign investors.
- **Improved geo-strategic situation** — the rapid conclusion of the war in Iraq (without Israeli involvement), the renewed involvement of the American administration in the Israeli-Palestinian conflict and its efforts to implement the 'road map', and the decrease in terrorist attacks, led to a sharp drop in the risk premium of the Israeli economy, derived from the geo-strategic environment.
- **Guarantees obtained from the U.S. Government** — in May 2003, Congress approved guarantees to the Israeli Government for the purpose of raising capital abroad, in the amount of \$9 billion for three years. This enabled the Israeli Government to raise capital abroad at a cost significantly lower than the cost of independent issues. The opening of this additional financing channel led to a reduction in Government issues on the domestic market as well, thereby lowering pressure in the domestic market. In fact, despite the increase in the Government deficit, from NIS 18.7 billion in 2002 to NIS 27.7 billion in 2003, domestic tradable funding remained almost unchanged, thanks to the increase in Government capital raising

Developments in the Domestic Government Bonds Market and in the Global Bonds Markets in 2003

Developments in the Domestic Government Bonds Market and in the Global Bonds Markets in 2003

abroad (both through issues backed by U.S. Government guarantees and through independent issues). This led to a decrease in yields in the domestic market, and allowed private companies to raise money from the public.

- **Recovery of major global stock exchanges** — in 2003, the downward trend that had characterized stock markets worldwide in the preceding years was reversed. Sharp price gains in global stock markets directly impacted the TASE, which enjoyed a considerable increase in turnovers as well as sharp price gains.

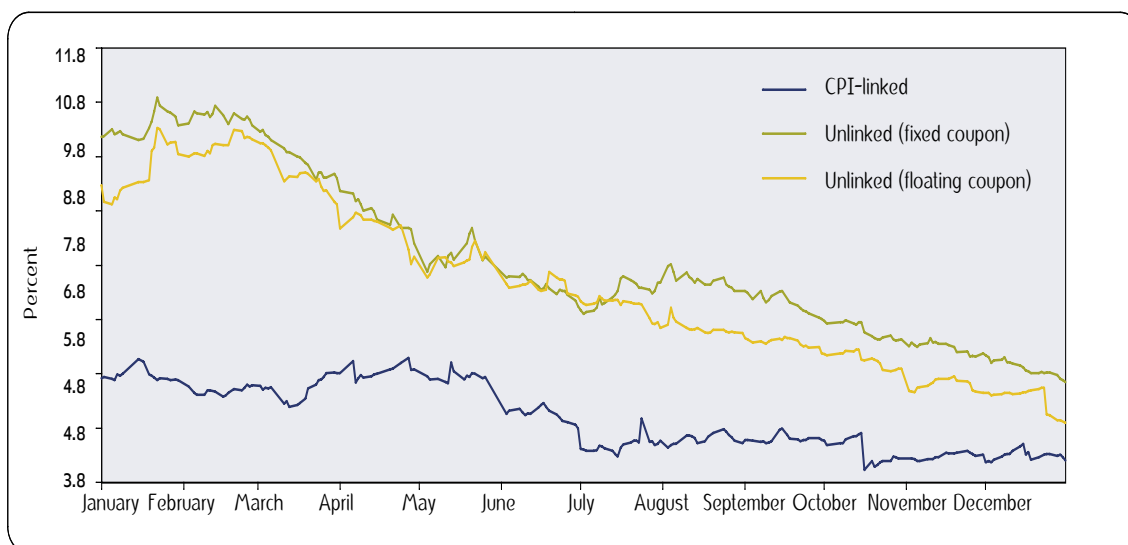
In 2003, implementation of the new tax regulations also began, and despite concerns prior to the application of the tax, activity in the stock market expanded, and turnovers grew by some 50% in comparison to the previous year.

2. Major Developments in the Domestic Government Bonds Markets

Holders of Government bonds enjoyed decreasing yields and rising prices throughout 2003. The prices of Government bonds gained 13.6% on average in 2003, while CPI-linked Government bond prices rose by 10.0%, and unlinked bond prices rose by 19.7%.

In the first two months of the year, the bonds market operated under the conditions of uncertainty that preceded the war in Iraq, which led to a certain increase in yields of unlinked bonds. However, the swift conclusion of the war, the Bush administration's 'road map' initiative, and the approval of the guarantees greatly reduced uncertainty in the markets, causing decreases in yields and prices increases, which persisted through the end of the year.

**Diagram B-2: Average yields of Government bonds in 2003
(weighted average)**



Source: Government Debt Management Unit, Ministry of Finance



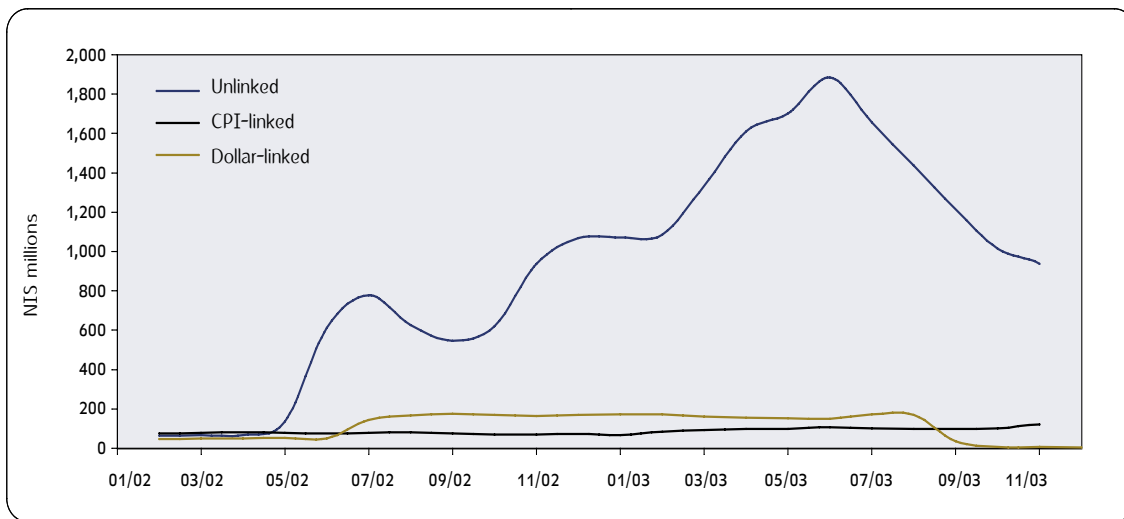
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Average daily trading volumes in Government bonds (within the TASE and over the counter) remained at a high level of approximately NIS 643 million. While these trading volumes are 7.5% lower than those of 2002, they are 40.2% higher in comparison to 2001. It should also be noted that trading in Government bonds remained a key component of overall activities on the TASE, again this year, at a rate of 40.8%.

The continued decrease in the interest rate in the United States during the first half of the year led many investors worldwide to seek high-yield bonds. The decreased risk environment of the Israeli economy and the high yields made Israeli Government bonds, especially the unlinked bonds, particularly attractive. As a result, foreign investors provided an inflow of large sums of money into the domestic Government bonds market in the first half of the year, and the volume of their holdings in Government bonds grew by 60% during this period, to NIS 2.2 billion. Foreign investments focused primarily on unlinked 'New Gilon' and 'Shahar' bonds, and the volume of their holdings in these bonds reached an approximate NIS 1.9 billion at the end of June 2003. However, various limitations, specifically the absence of primary dealers in Government bonds, left the foreigners' market share at only one percent, virtually all of which is held for the short term only, rather than the long term. The importance of primary dealers in this regard is due to the access of the global banks which would be primary dealers to large institutional investors in Europe and the United States, and the confidence they would provide to those investors.

In the second half of the year, the yield spread between Israeli Government bonds and U.S. Government bonds narrowed. Consequently, foreigners realized a considerable part of their investments and despite the continued price increases, their holdings diminished and reverted to the levels of the first quarter. Large international banks joining the market as primary dealers would create an ongoing commitment on their part to the domestic bonds market, making their presence in the domestic market permanent, rather than opportunistic, as it has been thus far. Based on experience in other countries, such a permanent presence would also be achieved through acquisitions and collaborations between the foreign banks and local financial entities, which could provide these banks with a marketing and distribution infrastructure and an in-depth knowledge of the local capital market (see details in Section D).

Diagram B-3: Foreign investors' holdings of Government bonds by indexation, 2002-2003

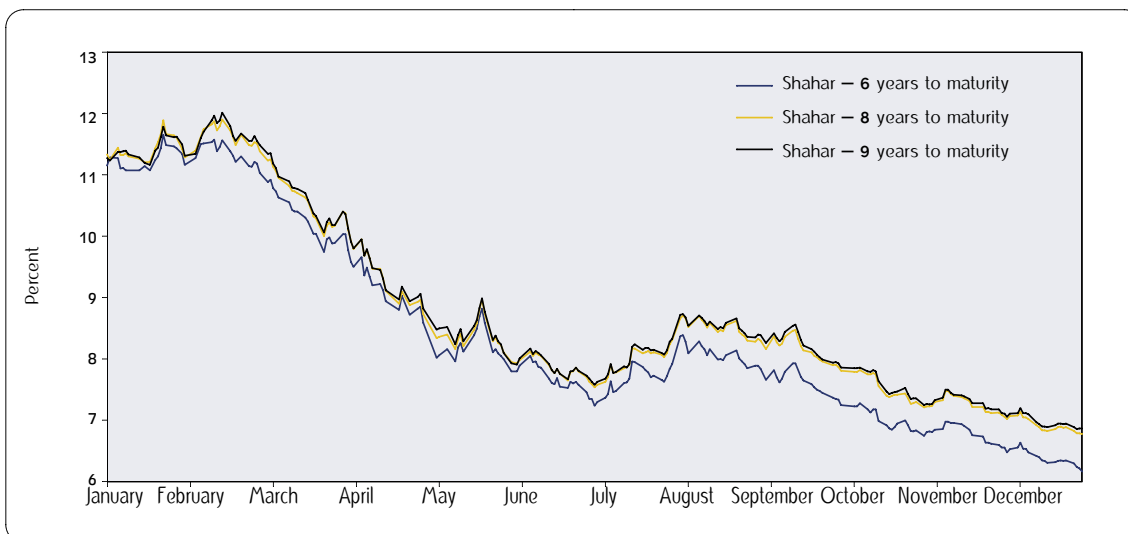


Source: Bank of Israel

A. Non-Linked Bonds

Fixed Interest Rate — beginning in February 2003, unlinked fixed-coupon bonds ('Shahar') recorded a decline in yields that continued throughout the year. The average yields of unlinked fixed-coupon bonds fell by 4.5% (from 10.2% at the end of 2002 to 5.7% at the end of 2003), while prices rose at an average nominal rate of 24.2%. Average daily trading volumes in unlinked fixed-coupon bonds grew by 9.7% in 2003, to NIS 295 million, constituting nearly half of the total trading volume in Government bonds.

Diagram B-4: Yields of unlinked fixed-coupon bonds with different terms to maturity in 2003

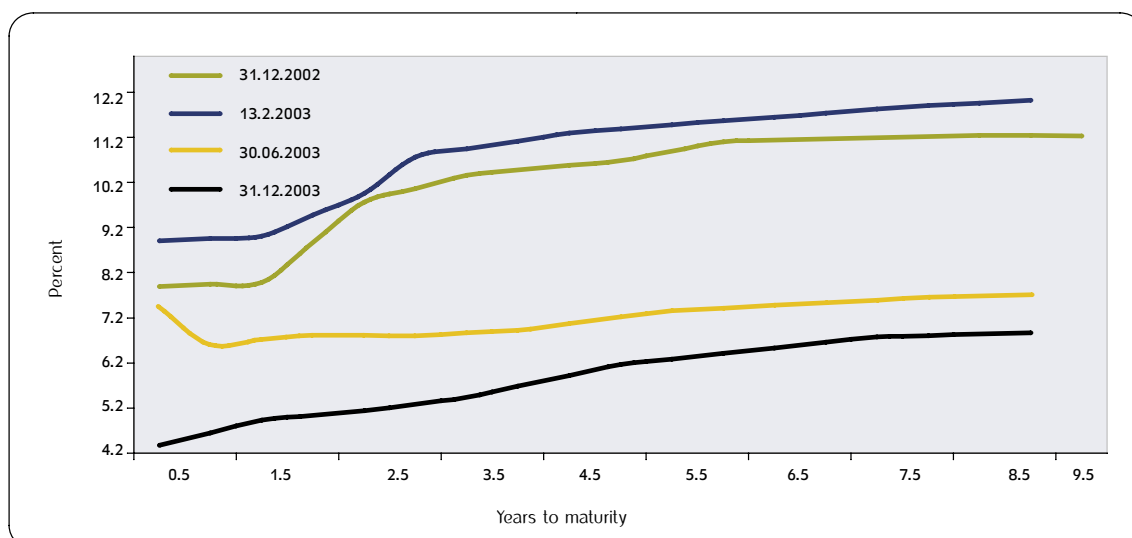


Source: Government Debt Management Unit, Ministry of Finance.

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In the first six weeks of 2003, a moderate increase was recorded in yields of unlinked fixed-coupon bonds. The increase began in November 2002, due to the uncertainty preceding the election in Israel, and the American preparations for the invasion of Iraq, and reached its peak on February 13, 2003. With the establishment of the Government in February and the rapid conclusion of the war in Iraq⁴, yields of unlinked fixed-coupon bonds for all terms to maturity began to fall swiftly. The decrease in yields was checked in July, due to a certain degree of depreciation in the shekel exchange rate, as well as the belief that in light of the decrease in the interest rate and the reduced spread vis-à-vis interest rates abroad, the Bank of Israel would not be able to persist in lowering the interest rate for long. However, beginning in September, the trend of decreasing yields resumed, due to the strength of the shekel against the dollar, and the low expected inflation rate, which enabled the Central Bank to sustain its policy of lowering the interest rate.

Diagram B-5: Yield curves of unlinked fixed-coupon bonds in 2002-2003



Source: Government Debt Management Unit, Ministry of Finance.

Diagram B-5 presents the yields of unlinked fixed-coupon bonds for various terms to maturity (hereafter: "yield curves"). The yield curve rising from left to right is the 'normal' curve, reflecting the risk premium that investors demand for a long-term investment over a short-term investment. In contrast, a flat curve represents the premium offset by expectations of a decrease in the interest rate. When the market expects the interest rate to rise, yields of long-term bonds rise relative to yields of short-term bonds, and the slope of the curve increases.

⁴ Note that the decrease in yields began even before the outbreak of the war, due to the belief that if the war did begin, it would end quickly.

In the first six weeks of the year, yields rose for all terms to maturity due to the anticipated war in Iraq, and yields of unlinked fixed-coupon bonds reached 12% in the long terms to maturity. The high yields in the short terms to maturity during this period may also be attributed to the fact that following the tax reform, holders of unlinked fixed-income bonds paid taxes on interest, whereas the *Makams*, which do not generate interest, were not taxed at all during 2003. This led to a reduced demand for unlinked fixed-coupon bonds in the short ranges, and increased their yields relative to the medium and long ranges. From the end of the war in Iraq to the end of the second quarter, yields in all ranges fell sharply, particularly in the long ranges, flattening the yield curve. In the third quarter, yields of unlinked fixed-coupon bonds remained almost unchanged in the long ranges, while in the short ranges yields decreased, so that the yield curve took on a 'normal' positive slope.

Floating Interest Rate — like the yields of unlinked fixed-coupon bonds, yields of FRNs ('Gilon' and 'New Gilon') declined during most of the year. Yields of FRNs decreased by an average 4.5% (from 9.4% at the end of 2002 to 4.9% at the end of 2003), and average prices rose at a nominal rate of 13.9%. Average daily trading volumes in FRNs grew by 12.6% this year, reaching NIS 116 million.

The interest rate of these bonds changes periodically (every six months for 'Gilon' bonds; every quarter for 'New Gilons'), according to the weighted average of *Makam* yields at terms to maturity of three to twelve months. This yield is the underlying asset of FRNs, and the yield gap at which the bonds are traded is measured in relation to it. The gap between a bond's yield and the yield of its underlying asset is called the 'spread'. The spread is positive when the bond's yield is higher than the yield of its underlying asset; the spread is negative when the bond's yield is lower than the yield of its underlying asset. Since the interest rate of FRNs is updated periodically, during times of decreasing interest rates investors will prefer fixed-coupon bonds, which are expected to record higher capital gains. Thus, the spread of FRNs is expected to increase as well. In contrast, during times of an expected increase in the interest rate, investors will prefer FRNs, which provide protection in case of an increase in interest, so that the spread is expected to decrease.

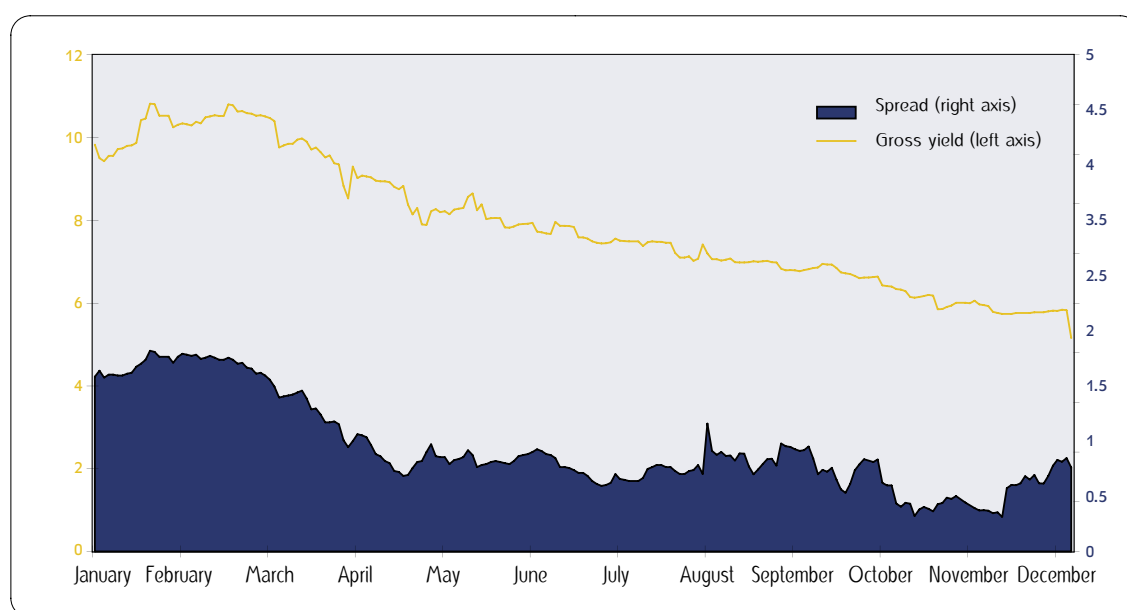
Diagram B-6 shows the spread between the *Makam* and yields of FRNs with an eight-year term to maturity. At the beginning of the year, the spread was 1.5%-2.0%. Beginning in February, the spread began to decrease, stabilizing at a level of one percent in May. In October, the spread decreased further, to less than 0.5% by the end of November. In the last month of the year, due to a decline in *Makam* yields, the spread rose back to a level of one percent. Two main causes can be noted for the large demand, the decline in yields, and the declining spread during most of the year:

1. The longer the reductions in the interest rate by the Bank of Israel continued, and as the gap between the Bank of Israel interest rate and foreign interest rates diminished, investors increasingly believed that the level of interest rates reached by the economy was low, and that the possibility of continued interest rate reductions by the Bank of Israel was limited. Therefore, FRNs became attractive, and demand for them increased, driving down their yields as well as their spread.

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2. In accordance with the tax regulations that took effect in January 2003, holders of FRNs paid a tax of 10% on interest⁵ in 2003, while holders of Makam bonds were exempt from taxation. Beginning in January 2004, Makam holders began to pay tax on capital gains obtained from that date onwards (including for bonds issued in 2003). Therefore, throughout 2003, the advantage of holding Makams over FRNs declined, so that the relative price of Makams and the yield spread diminished.

Diagram B-6: Yields of FRNs with an eight-year term to maturity, and the spread between these yields and the yields of the underlying asset in 2003 (percent)



Source: Government Debt Management Unit, Ministry of Finance.

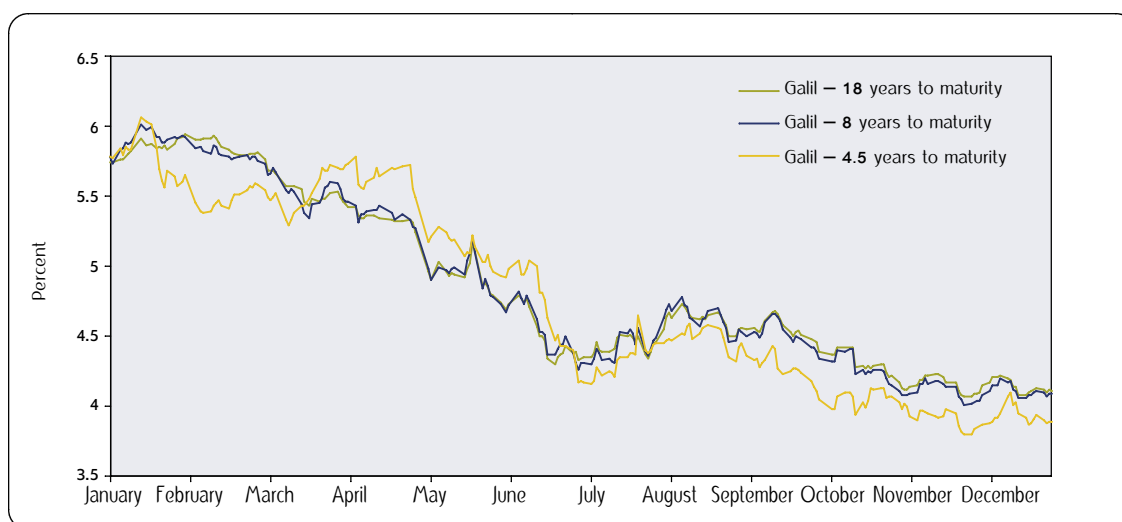
B. CPI-Linked Bonds

Like the unlinked channels, yields of long-term CPI-linked channels fell throughout almost all of 2003. Yields of CPI-linked bonds dropped by an average of 1.6% (from 5.9% at the end of 2002 to 4.3% at the end of 2003), and their average prices increased at a nominal rate of 10%, compared to 1.1% in 2002. In real terms, prices of CPI-linked bonds rose by 12.1% in 2003, compared to a decrease of 4.6% in 2002. Average daily trading volumes in CPI-linked bonds decreased by 5.7% this year, to approximately NIS 198 million.

⁵ Four out of seven unlinked fixed-interest bonds which were traded at the end of 2003 were issued after May 2000, and the new tax regulations apply to them.

In July, the decline in yields halted, and even slightly reversed, as a result of the depreciation in the shekel exchange rate against the dollar. However, similarly to the developments in unlinked bonds, the trend of declining yields in the market resumed beginning in August.

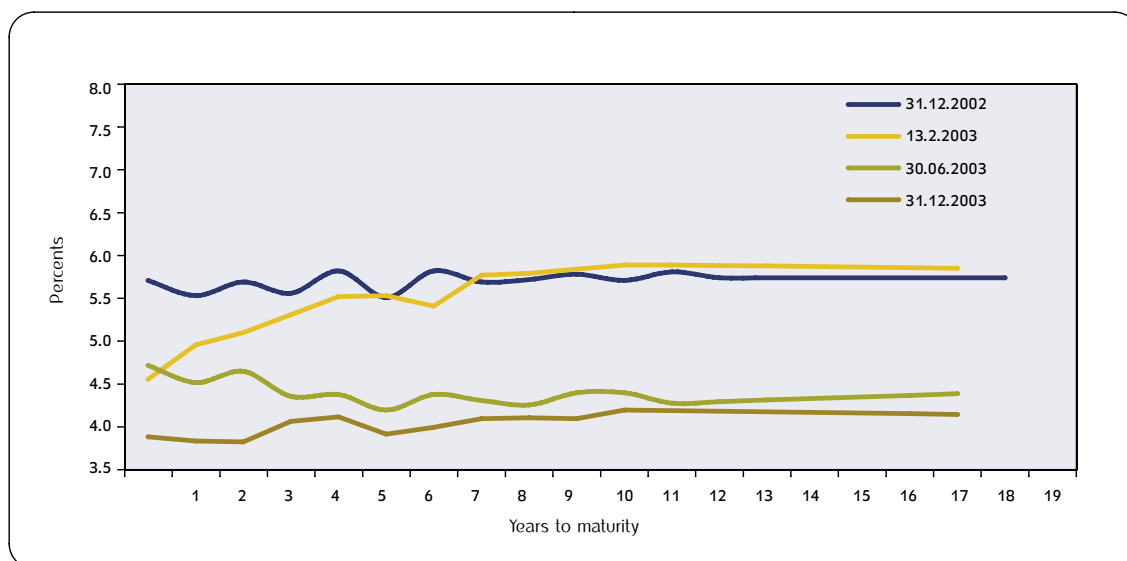
Diagram B-7: Yields of CPI-linked bonds for different terms to maturity in 2003



Source: Government Debt Management Unit, Ministry of Finance

Diagram B-8 presents the yield curves of CPI-linked bonds for different terms to maturity. In the beginning of the year, the demand for short-term CPI-linked bonds grew, due to the uncertainty concerning the security situation and concerns that this would lead to a renewed inflationary outbreak, so that their yields decreased sharply. When the war began and the sense of certainty returned to the markets, the demand for CPI-linked bonds in these ranges declined; together with the low expected inflation rate, this caused a sharp increase in yields and caused the curve to become negative and sharply sloped. A negative curve indicates expectations of a sharp decrease in the real interest rate in the economy. Later in the year, yields declined in all terms to maturity, and the curve became flattened. This curve structure indicates expectations of a moderate decrease in the real interest rate, since the decline in yields in the long ranges compensates for the liquidity premium required. This characterized the second half of the year, due to the belief that the continuing decrease in the Bank of Israel interest rate and the low level of prices would lessen the chances of a sharp decrease in the real interest rate.

Diagram B-8: Yield curves of CPI-linked bonds in 2002-2003



Source: Government Debt Management Unit, Ministry of Finance

C. Dollar-Linked Bonds

In 2003, two additional series of 'Gilboa' type foreign currency-linked bonds were redeemed, and only three series, at a volume of NIS 5.7 billion, remained in circulation. Two more series were redeemed in January and July 2004, leaving only one series in circulation, with a negligible volume of some NIS 300 million.

A series with a volume of NIS 3.5 billion was redeemed in March, and an NIS 5.2 billion series was redeemed in September. Despite earlier concerns that the redemption of large dollar-linked bond series would increase demand for foreign currency and lead to depreciations and inflationary pressures, both redemptions passed without significant shocks to the foreign currency markets. One reason was the entry of private financial entities which issued structured financial instruments based on high-rated foreign financial assets. In 2002 and 2003, capital raising in dollar-linked corporate bonds totaled NIS 3.3 billion (approximately 55% of the total capital raised via corporate bonds during the period). The Ministry of Finance views the developments in the corporate bonds market and the entry of private entities into the foreign currency-linked bonds market as highly favorable.

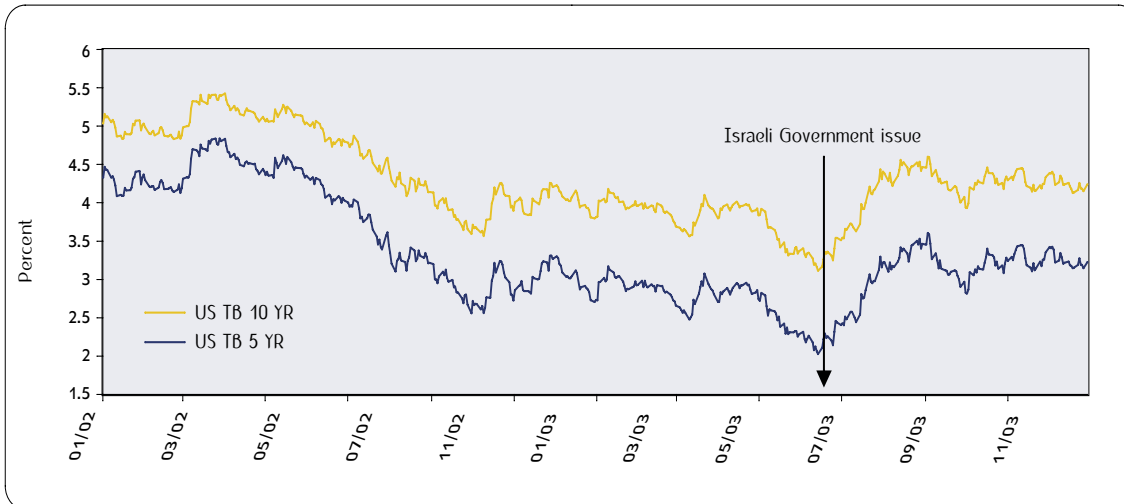
3. Developments in the Global Bonds Market

Interest rates in United States and European bonds markets remained low during 2003. Yields of ten-year U.S. Government bonds ranged from 3.11% at the low point in June, to 4.60% in the beginning of September. In Europe, yields of German Government bonds ranged from 3.47% in June to 4.50% in the beginning of November.

Developments in the Domestic Government Bonds Market and in the Global Bonds Markets in 2003

Developments in the Domestic Government Bonds Market and in the Global Bonds Markets in 2003

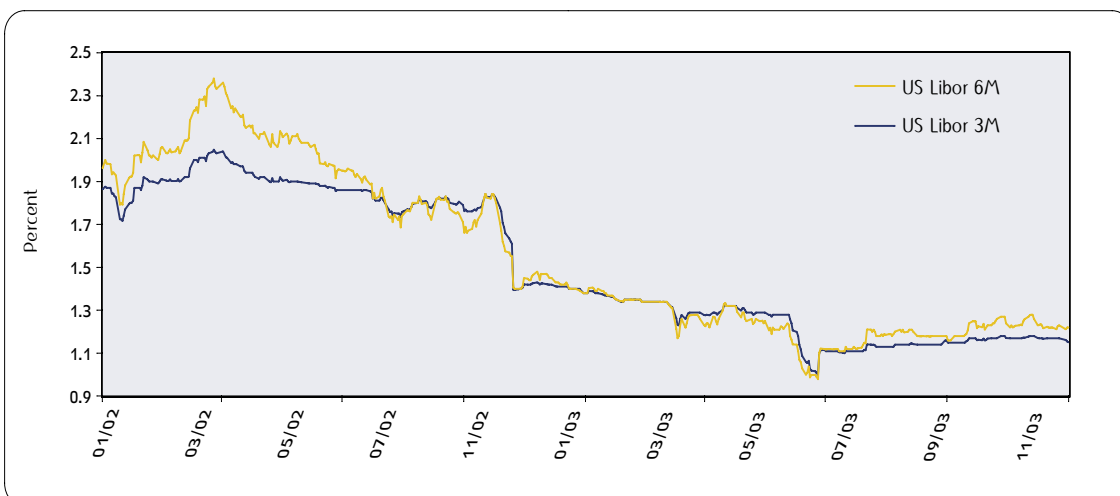
Diagram B-9: Developments in yields of U.S. Government bonds for five and ten years to maturity in 2002-2003



Due to the low level of yields, and following the swift conclusion of the fighting in Iraq, there was brisk demand in the second half of the year for bonds that provide an excess yield over Government bonds of the developed economies, leading to an increased demand for issues of emerging markets, such as Israel, Korea, South Africa, and Eastern and Central European countries. Due to this demand, spreads for A-rated countries such as Israel declined.

The level of short-term interest rates remained very low during the year, both in the United States and in Europe, as a result of the low basic interest rates, 1% in the U.S. and 2% in Europe, maintained by the European Central Bank (ECB) and by the Fed. The LIBOR curve was steep for most of the year, due to the unrealized expectations of an increase in interest rates when growth shall resume in the United States.

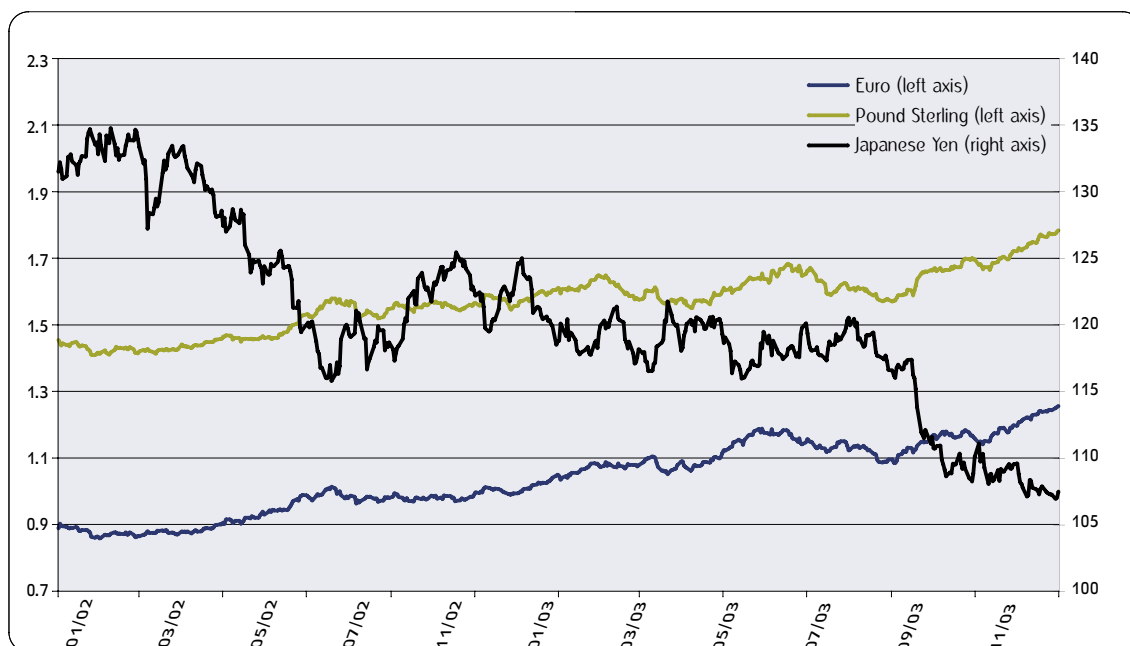
Diagram B-10: Developments in the LIBOR interest rate for three and six months in 2002-2003



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In the foreign currency market, the continued weakening of the dollar against the Euro continued, from a low point of \$0.86 per Euro in the beginning of 2002, to an all-time record of \$1.26 per Euro at the end of the year, a trend that began in March 2002. The weakening stemmed from the interest rate gap between the U.S. and Europe, the immense deficits in the U.S., and the currency distribution policy of the central banks in East Asia.

Diagram B-11: Developments in dollar exchange rates against the Japanese Yen, the Euro, and the Pound Sterling in 2002-2003

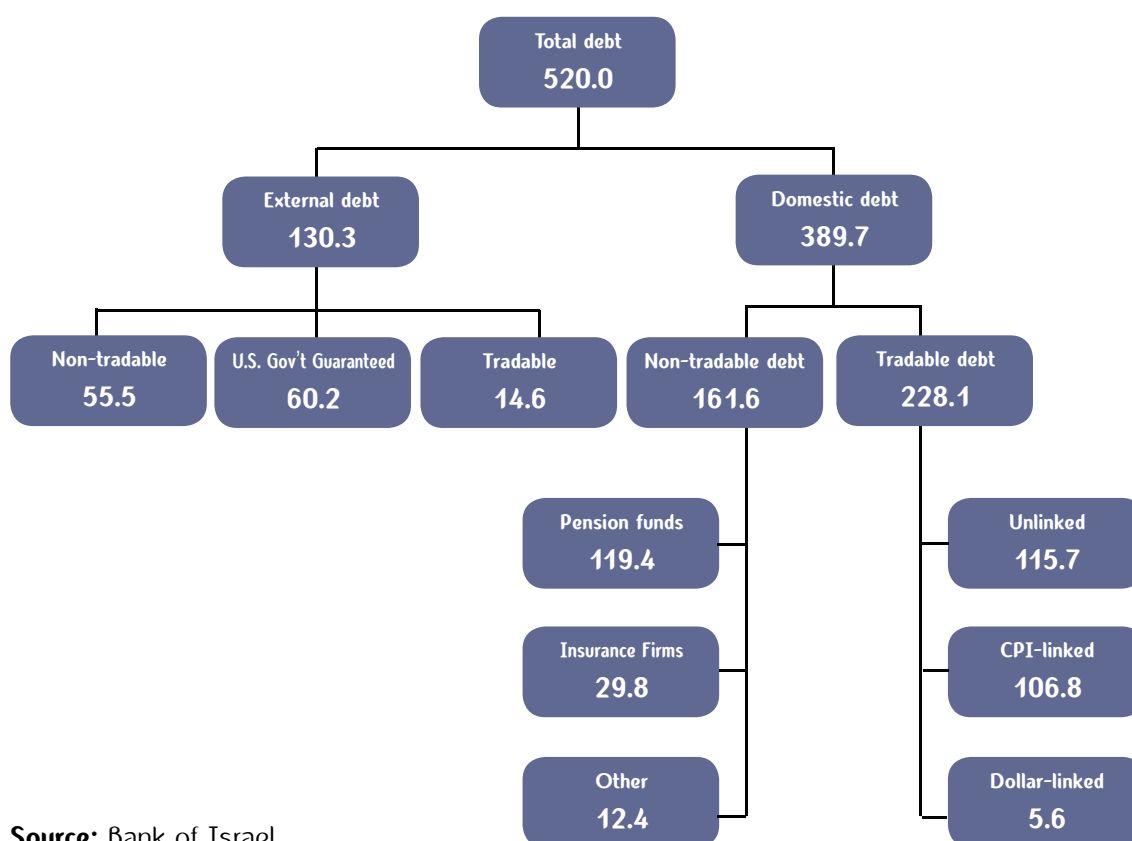


In the stock markets, prices rose almost continuously from March to the end of the year, with gains of over 50% in some stock indices. This increase resulted from the swift conclusion of the war in Iraq, the low level of interest rates in all of the markets, which left no alternative investment channels to stocks, and the renewed growth in the United States and the Far East.

1. Government Debt in 2003

At the end of 2003, overall Government debt totaled NIS 520 billion, compared with NIS 502 billion in 2002 – a real increase of 5.6%. Domestic debt totaled NIS 390 billion at the end of 2003, compared with NIS 372 billion at the end of 2002 – a real increase of 6.7%, while external debt remained virtually unchanged, in nominal terms, totaling NIS 130 billion at the end of 2003, similar to the end of 2002 – a real increase of 1.9%.

Diagram C-1: Structure of Government debt at the end of 2003
(NIS billions)



Source: Bank of Israel.

A. Government Debt and Debt to GDP Ratio

The ratio of Government debt to GDP reached a level of approximately 104.8% at the end of 2003, compared with 103.0% at the end of 2002. This increase is a result of two main factors:

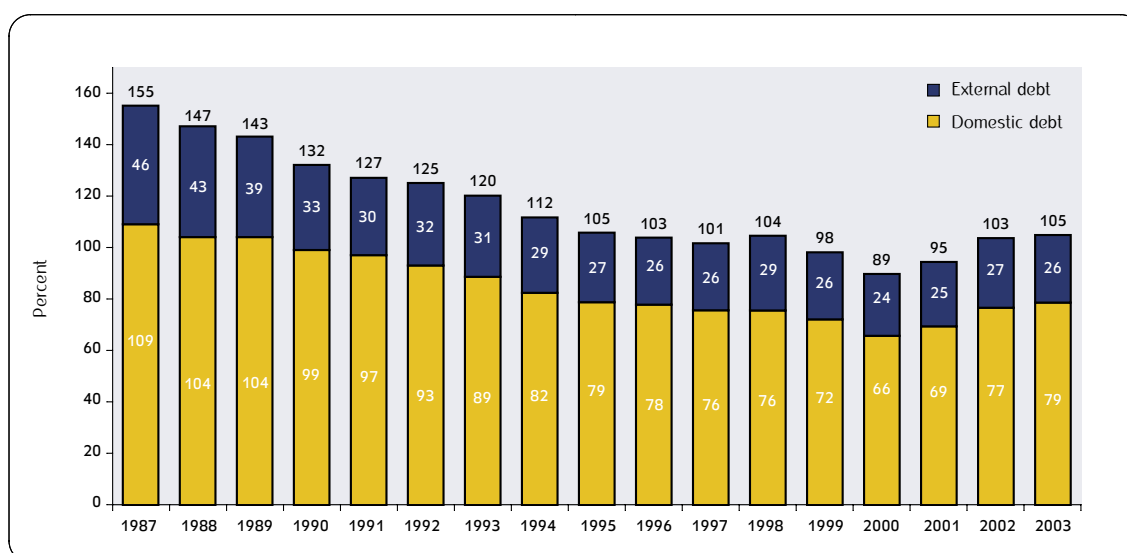
1. Government revenues from taxes were lower than expected, leading to a considerable deficit in the Government budget (NIS 25.9 billion).
2. A low GDP growth rate of only 1.3%⁶.

⁶ It should be noted that the decrease in the debt/GDP ratio, beginning in the mid-1980s, was the result of an increase in GDP, rather than a decrease in the volume of debt in either nominal or real terms.

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The increase in the Government debt to GDP ratio in the last three years contradicted the multi-year trend of decreases in the ratio of Government debt, a trend which characterized the Israeli economy from the stabilization plan in 1985, up until 2000. An examination of the development of the debt to GDP ratio from 1995 to 2000 indicates a considerable, relatively rapid decline of some 3.2 percent each year (on average). This decrease was due primarily to the growth of the Israeli economy and the GDP itself, but also to increases in State revenues, privatization, and fiscal restraint, which was preserved despite the many pressures and constraints. Maintaining budgetary discipline, coupled with a resumption of growth, will return the Government debt to a downward trajectory.

Diagram C-2: Government debt to GDP ratio, 1987-2003



Source: Bank of Israel

Although the growth in the Government deficit and in the debt to GDP ratio in recent years are not unique to the Israeli economy, and, as illustrated in Table C-1, have characterized many of the developed economies, an entry into a prolonged trajectory of deficits and a growing debt to GDP ratio may damage confidence in the markets and impair the economy's financial stability. Moreover, it should be noted that reduction of the debt lowers interest payments, which are a heavy burden on the State budget and on the Israeli economy. Note that the total debt burden (principal + interest) in the budget for 2003 (without the Bank of Israel and National Insurance) is NIS 75.5 billion, equal to 31.1% of the State budget.

Table C-1

Deficit and total debt as a percentage of GDP in selected countries in 2003

Country	Surplus (+) / deficit (-) in the Government budget as a percentage of the GDP	Overall debt as a percentage of the GDP
Israel ⁽¹⁾	-5.6	104.8
Belgium	+0.2	105.1
Greece	-0.3	103.0
Italy	-2.5	116.7
Japan	-8.0	157.3
Ireland	0.2	32.8
Britain	-3.2	51.6
USA	-4.8	62.8
Germany	-3.9	65.1
France	-4.1	71.1
OECD average	-3.7	76.0

(1) The deficit in Israel is calculated deducting the inflation component of the CPI-linked debt. Overall debt includes the inflation component of the linked debt, and unpaid accrued interest.

Sources: OECD Economic Outlook; Ministry of Finance.

B. Domestic Debt

The balance of domestic debt (tradable and non-tradable, excluding the debt of the National Insurance Institute) amounted to approximately NIS 390 billion at the end of 2003. The tradable debt grew by 8.1%, totaling an approximate NIS 228 billion at the end of the year, 58.6% of the total domestic debt. The non-tradable debt grew by only 0.2% in 2003 and totaled approximately NIS 161 billion at year end, or 41.4% of overall domestic debt. This year, again, the growth rate of tradable debt was higher than the growth rate of non-tradable debt, increasing its share of the overall debt, as detailed in Table C-2 below.

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Table C-2
Distribution of domestic debt – tradable and non-tradable, 1998-2003⁽¹⁾
(percentages)

Type of debt	1998	1999	2000	2001	2002	2003
Tradable debt	52	53	54	55	58	59
Non tradable debt	48	47	46	45	42	41

(1) Excluding National Insurance.

Source: Bank of Israel and the Government Debt Management Unit.

(1) Tradable debt

In 2003, the share of the unlinked component in the overall domestic tradable debt increased sharply at a rate of 7.7% (from 43.0% at the end of 2002 to 50.7% at the end of 2003), at the expense of the CPI- and USD-linked components (the proportion of CPI-linked debt fell by 2.9%, to 46.8%, and the proportion of USD-linked debt fell by 4.8%, to 2.5%, during the period under review). As shown in Table C-3, since 1995, the share of the unlinked debt has grown by 41.9 percentage points; from a component of secondary significance, it has become the primary component of tradable domestic debt. This trend is in line with the Ministry of Finance's trend of de-linking prices ('shekelization'), as well as compatibility with other countries, since most issues of various countries are of unlinked debt.

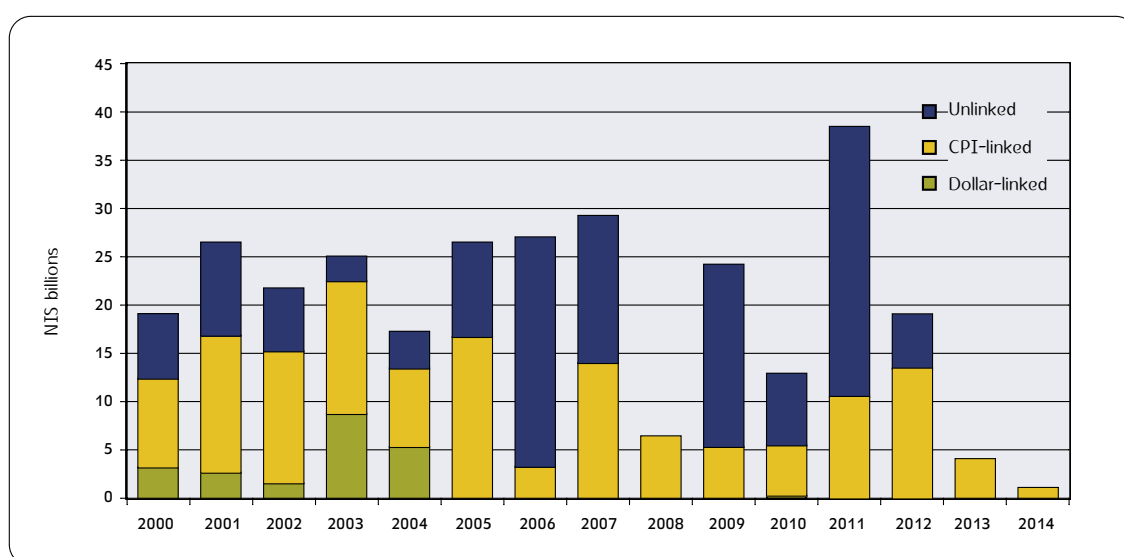
Table C-3
Distribution of the tradable debt by linkage type in 1998-2003
(percent)

Tradable debt	1995	2000	2001	2002	2003
CPI linked	81.3	58.5	52.8	49.7	46.8
Dollar-linked	9.8	11.1	8.8	7.3	2.5
Unlinked	8.8	30.4	38.4	43.0	50.7

Source: Bank of Israel and the Government Debt Management Unit.

The aforementioned development is based on two key processes: the growth of the unlinked component in the Government's tradable funding mix, and the large redemptions of CPI- and foreign currency-linked tradable bonds. In 2003, redemptions of linked bonds totaled NIS 22.5 billion, compared with redemptions of unlinked bonds in the amount of only NIS 2.6 billion. However, as shown in Diagram C-3, in the coming years the share of unlinked bonds out of total tradable redemptions will grow considerably, and the sharp increase in the proportion of the unlinked channel out of overall tradable domestic debt is expected to level off.

Diagram C-3: Tradable domestic redemptions by linkage type, 2000-2014
(principal only)



Source: Bank of Israel

● Distribution of Holdings of Tradable Government Bonds

In 2003, holdings by the mutual funds and insurance companies as a share of total holdings of Government bonds increased, while the proportion of holdings by provident funds, pension funds, banks, and foreign investors decreased. As in previous years, the low weight of pension funds and foreign investors in the Government bonds market is notable. The entry of these two sectors could create a large inflow of demand in the market, decrease yields, and raise tradability.

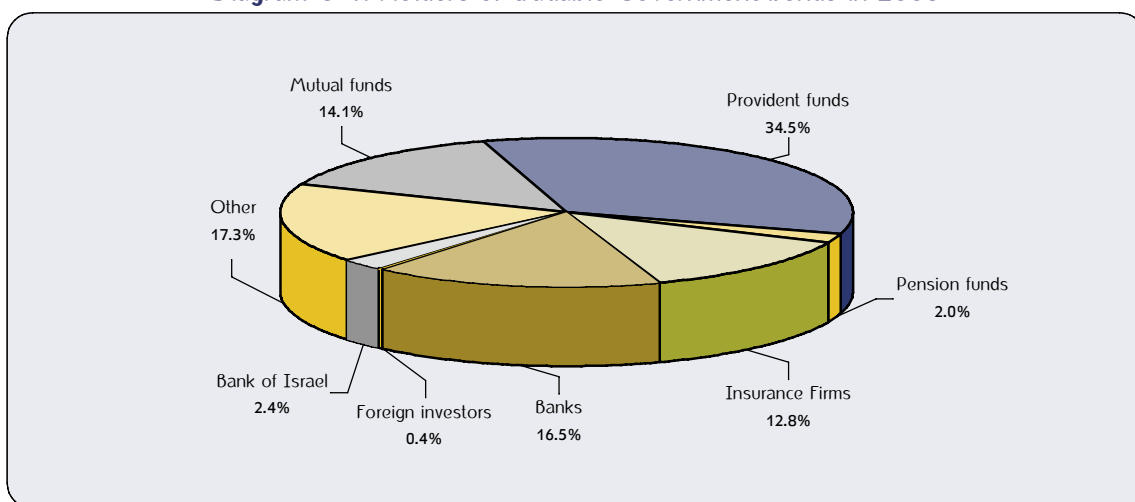
An examination of the distribution of holdings of tradable Government bonds in 1995-2003 indicates long-term trends that are in line with the changes in preferences of investors in the capital market. The holdings of banks and provident funds as a share of total holdings of Government bonds decreased by 11.8% and 8.7%, respectively, since 1995. In contrast, mutual fund holdings have grown by 9.2%.

Table C-4
Distribution of holders of tradable Government bonds in 1995-2003
(percent)

Year	Total market value (NIS)	Other	Mutual funds	Provident Funds	Pension Funds	Banks	Insurance Firms	Foreign Investors	Bank of Israel
1995	105.2	17.3	4.9	43.2	0.0	28.3	2.8	0.5	3.0
2000	157.3	16.1	12.1	41.0	1.3	18.1	7.0	0.3	4.2
2001	181.0	12.4	15.4	40.4	1.0	15.8	11.1	0.1	3.7
2002	197.1	16.2	10.1	36.5	2.2	19.2	12.1	0.7	3.0
2003	229.6	17.3	14.1	34.5	2.0	16.5	12.8	0.4	2.4

Source: Bank of Israel

Diagram C-4: Holders of tradable Government bonds in 2003



Source: Bank of Israel

● Size and Number of Series

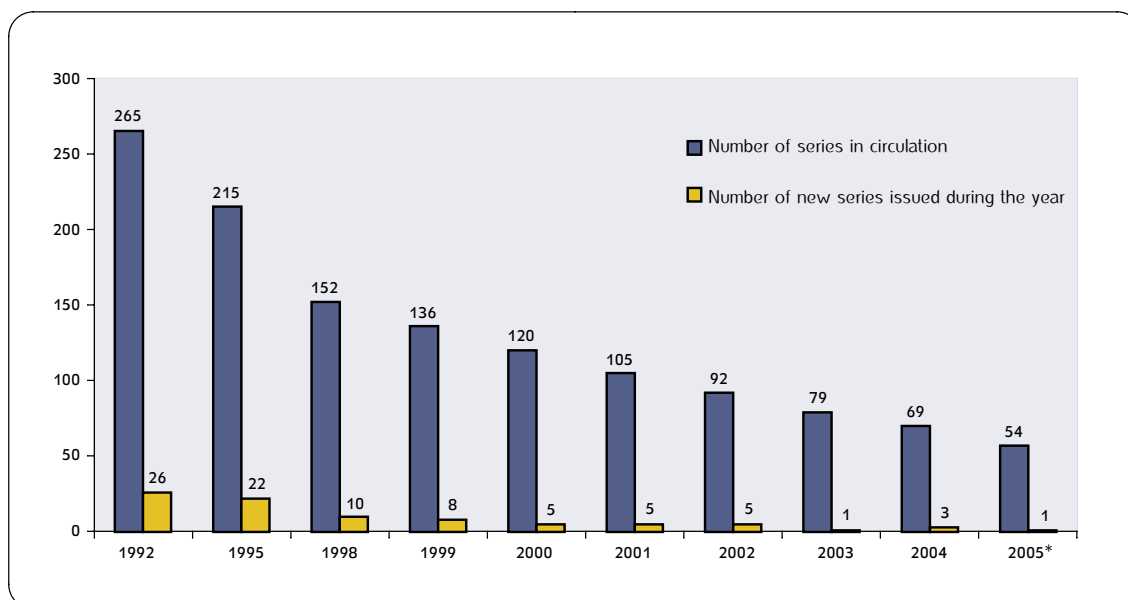
As part of the effort to enhance tradability and liquidity in the domestic bonds market, the Ministry of Finance reduced the number of series and sharply expanded their volume in recent years (see details in Section A).

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Only one new bond series was issued in 2003, while fourteen bond series reached maturity. As a result, the number of series traded continued to fall (as shown in Diagram C-5), to 79 at the end of 2003.

Diagram C-5: Number of series of tradable Government bonds, 1992-2005

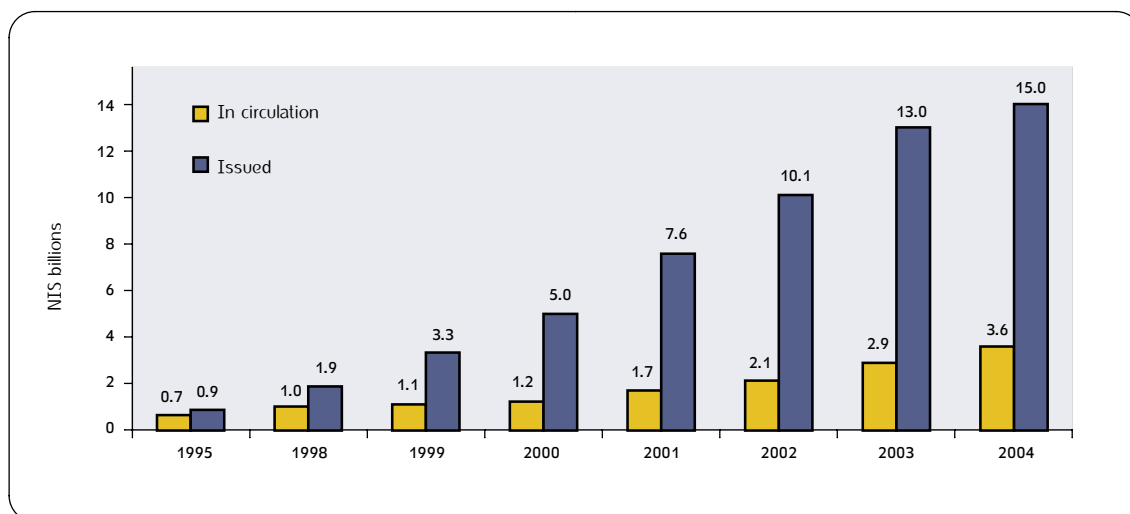


* Estimate

Source: Government Debt Management Unit, Ministry of Finance

In 2003, the trend of increasing volumes of both new and traded series continued. As shown in Diagram C-6, the average size of new series grew by 28.7%, to approximately NIS 13.0 billion. As a result, the average size of traded series grew by 35.5%, to NIS 2.9 billion. Maintaining issuance of large series, together with the continued redemption of small series, will cause this trend to continue.

Diagram C-6: Average size of series, 1995-2004



Source: Government Debt Management Unit, Ministry of Finance

(2) Non-tradable debt

Table C-5 illustrates the composition of the non-tradable debt in 1998-2003. A moderate increase over the years can be identified in the rate of nontradable 'Miron' bonds issued to 'old' pension funds, as can the sharper increase in the rate of 'Arad' type nontradable bonds issued to new pension funds. In contrast, the rate of the 'miscellaneous' component out of the total non-tradable debt has decreased. This item includes various loans, deposits, and emissions managed by the Ministry of Finance. Note that beginning in 1985, the emissions item has decreased considerably, and the balance of loans in this item has progressively declined over the years. In addition, the rate of 'Chetz' type nontradable bonds (issued to insurance firms) out of the total non-tradable debt, has remained virtually unchanged.

The new regulations taking effect with regard to investment in pension funds are expected to bring about a decrease in the share of their holdings in non-tradable debt.

Table C-5
Distribution of non-tradable debt, 1998-2003
(percent)

	1998	1999	2000	2001	2002	2003
Total (NIS billions)	144.0	145.4	141.9	148.4	161.0	161.6
Pensions:						
Miron	55	58	63	65	66	66
Arad	2	2	4	5	6	8
Other	1	-	-	-	-	-
Insurance:						
Hetz	21	21	20	19	19	18
Miscellaneous ⁽¹⁾	27	19	13	11	9	8

(1) Including various loans, deposits, and emissions managed by the Ministry of Finance.

Source: Bank of Israel.

● Average Term to Maturity

The average term to maturity of the **overall Government debt** (Table C-6) grew by 0.3 years in 2003, to approximately 6.9 years at the end of the year. The extension of the Government debt is due to the lengthened term to maturity of debt issued both in Israel and abroad, as well as the large redemptions. The average term to maturity of the **external debt** also grew sharply this year (by 1.4 years), in contrast to the trend in recent years, reaching 8.0 years at the end of the year. The extension of the external debt resulted from a renewal of capital raising under U.S. Government loan guarantees for maturities of 20 and 30 years. The external debt is expected to continue to lengthen in the coming years, due to the loan guarantees program. The average term to maturity of the **domestic debt** remained unchanged, at approximately 6.6 years at the end of 2003; however, the average term to maturity of the **tradable domestic debt** increased by 0.1 years over the past year, reaching 5.5 years at the end of 2003.

In contrast to the general trend, note that the **duration** of tradable debt decreased during the year, from 4.3 to 4.2 years, as a result of the issues of large volumes of short-term unlinked and linked bonds. In addition, the **modified duration** of the tradable debt, which reflects sensitivity of prices to changes in the interest rate, decreased from 3.0 to 2.9.



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Table C-6
Average term to maturity of Government debt, 1998-2003
(years)

	1998	1999	2000	2001	2002	2003
Domestic debt	6.4	6.3	6.2	6.5	6.6	6.6
Of which: tradable	4.6	4.5	4.5	5.1	5.4	5.5
External debt	8.0	7.6	7.1	6.9	6.6	8.0
Total Government debt	6.8	6.6	6.5	6.6	6.6	6.9

Source: Bank of Israel.

C. External Debt

The external debt of the State of Israel, like the domestic debt, is divided into tradable and non-tradable debt.

The tradable component of the external debt is composed of two types:

- (1) Bonds issued with U.S. Government guarantees, whose balance at the end of 2003 totaled \$13.7 billion.
- (2) Bonds issued on global markets without guarantees ('non-guaranteed issues'), whose balance at the end of 2003 totaled \$2.9 billion.

Between 1995 and 2003, eight non-guaranteed issues were carried out in the United States, Europe, and Japan. In 2003, one global tradable non-guaranteed issue was carried out, at a volume of \$750 million, and three issues were carried out with U.S. Government guarantees, at volumes of \$450 million, \$1.15 billion, and \$750 million. Tables C-7 and C-8 detail the parameters of the tradable issues carried out by the Ministry of Finance abroad in recent years.

Debt Management and Deficit Financing

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Table C-7

Non-Guaranteed issues in the global financial markets, 1995 - 2004⁽¹⁾

Year	Market	Amount in \$ millions	Currency	Term to maturity (years)	Coupon (%)	Benchmark	Margin from BM at date of issue (basis points)	Margin from SWAP curve on Dec. 19, 2003 (basis points)
1995	Yankee	250	Dollar	10	6.375	USA	76	91
1996	European	200	Dollar	5	6.375	USA	-	-
1997	Samurai	170	Yen	10	3.0	Japan	-	-
1998	Yankee	250	Dollar	30	7.25	USA	210	133
1999	European	412	Euro	7	4.75	France	95	72
2000	Global	500	Dollar	10	7.75	USA	135	78
2002	European	350	Euro	7	5.979	Germany	123	86
2003	Global	750	Dollar	10	4.625	USA	153	64
2004	Global	500	Dollar	10	5.125	USA	115	-

(1) All issues are of bonds bearing fixed interest.

Source: Government Debt Management Unit, Ministry of Finance.

Table C-8

Issues by the Government of Israel with U.S. Government guarantees in the global financial markets, 9/2003 - 6/2004⁽¹⁾

Month	Amount in \$ millions	Currency	Term to maturity (years)	Coupon (%)	Benchmark	Margin from BM at issue date (basis points)
September 2003	450	Dollar	30	5.5	USA	38
September 2003	1150	Dollar	20	5.5	USA	33
December 2003	750	Dollar	20	5.5	USA	36
April 2004	1000	Dollar	20	5.5	USA	31

(1) All issues are of bonds bearing fixed interest.

Source: Government Debt Management Unit, Ministry of Finance.

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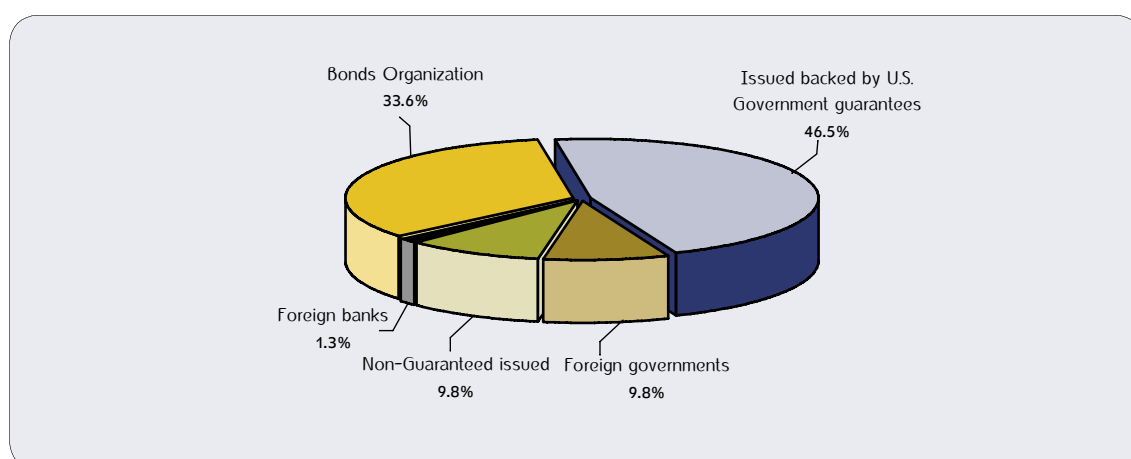
The non-tradable component of the debt is composed primarily of bonds issued over the years, to individuals, companies, and institutional entities, through the Bonds Organization (State of Israel bonds). The total balance of debt in Bonds Organization bonds totaled \$9.9 billion at the end of 2003. The remainder of non-tradable debt stems from issues to foreign governments, international institutions, and foreign banks. This balance totaled \$3.0 billion at the end of 2003.

● Main features of the External Debt

At the end of 2003, the Government's external debt amounted to approximately \$29 billion, or 26% of the total Government debt. In addition to the low rate of external debt out of the total Government debt, the external debt of Israel has several additional major characteristics:

- **The large share of Bonds Organization bonds and issues backed by U.S. Government guarantees out of total external debt** – at the end of 2003, Bonds Organization bonds and U.S. Government guaranteed issues amounted to some 80.1% of the total external debt. These bonds enjoy better financing terms as compared to non-guaranteed bonds. Bonds issued by the Bonds Organization are non-tradable, so that their sensitivity to shocks in international capital markets is low. These bonds comprised 33.6% of the total external debt at the end of 2003. Loans guaranteed by the U.S. Government benefit from low interest, since they are granted the U.S. Government's credit rating (AAA/Aaa), which is higher than the Israeli Government's credit rating (A2/A-). The A2 credit rating given to Israel by Moody's is equal to an A rating on the scale used by Fitch and Standard & Poor's; it is therefore one notch higher than the credit rating given to Israel by Fitch and Standard & Poor's. At the end of 2003, these bonds amounted to 46.5% of the total external debt (see Diagram C-7).

**Diagram C-7: Composition of external debt by source
(As of December 31, 2003)**



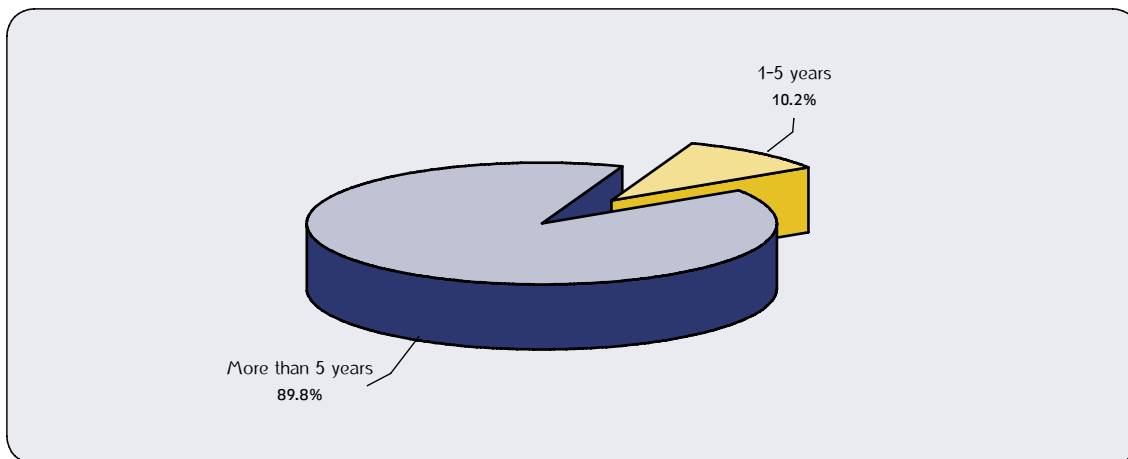
Source: Bank of Israel

Debt Management and Deficit Financing

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- **A long term to maturity** – capital raising by the Israeli Government is characterized by a relatively long term to maturity (at issue). At the end of 2003, the share of debt with an original term to maturity greater than five years amounted to approximately 89.8%, and the share of debt with an original term to maturity lower than five years was approximately 10.2%. The long-term debt structure contributes to the Government's financial stability.

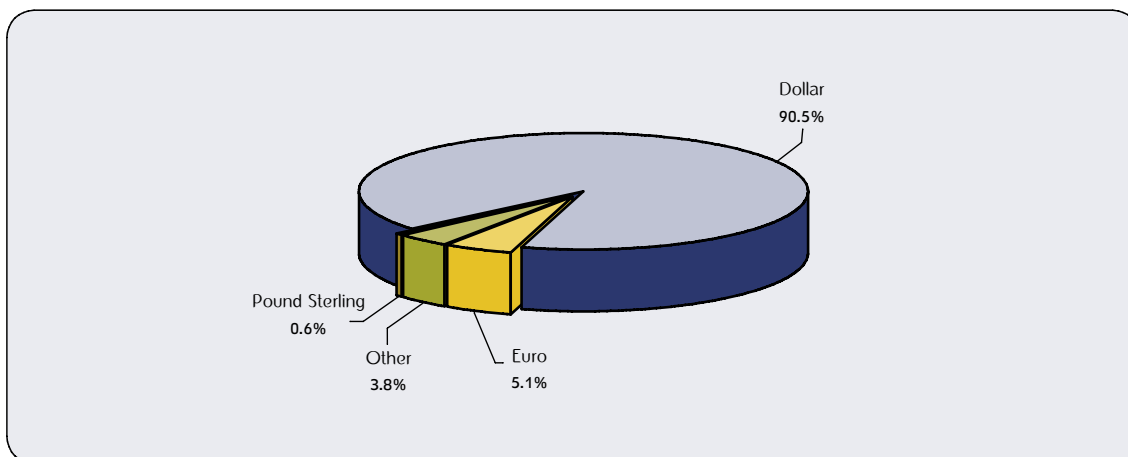
Diagram C-8: Composition of external debt by original term to maturity (at issuance)
(As of December 31, 2003)



Source: Bank of Israel

- **Significant dominance of debt denominated in U.S. dollars** – at the end of 2003, the rate of the Israeli Government's external debt denominated in U.S. dollars amounted to approximately 91% of the total external debt. This is due primarily to the high rate of debt backed by U.S. Government guarantees out of total external debt, and to the dominance of American investors in purchases of Bonds Organization bonds.

Diagram C-9: Composition of external debt by currency



Source: Bank of Israel

2. The Government Deficit and Financing Needs in 2003

The State budget (approved by the Knesset as the 'Budget Law') includes a forecast of the Government's expected income and expenses. Government income derives primarily from direct and indirect taxes collected by the Government, while Government expenses include all the activities of the Ministries and other entities that receive Government financing. The difference between the income and the expenses is the deficit, which needs to be financed.

There is a distinction, in terms of both the deficit and its financing, between the domestic deficit and the deficit or surplus abroad. However, the domestic debt can be financed by loans from abroad, and vice versa.

In 2003, as in every year, the Accountant General financed the deficit, plus roll-over of debt reaching maturity, deducting net loans received from abroad, and income obtained from privatization. The Debt Management Unit raised capital from the public in Israel via issues of tradable bonds, as well as through issues of non-tradable ('designated') bonds to institutional investors. In addition, the Debt Management Unit raised capital abroad through the Bonds Organization, through independent tradable issues, and through issues backed by U.S. Government guarantees.

In 2003, the Government's deficit and financing needs increased far beyond the amounts detailed in the State budget. One of the main factors leading to the growth in financing needs was the slowdown in economic activity, which led to an acute (and unexpected) decline in Government income from taxes. The economic slowdown also impeded the privatization process, which was an important source of financing for Government expenses in the 1990s.

The Government deficit (excluding net credit grants) for 2003 totaled NIS 27.7 billion, as compared to a planned deficit of NIS 15.2 billion in the State budget. Redemptions of principal totaled NIS 49.1 billion in 2003, of which NIS 35.1 billion were in the domestic market, and NIS 14.0 billion abroad. Privatization (net) totaled only NIS 270 million. In conclusion, a total of NIS 78.3 billion was raised in 2003, of which NIS 57.6 billion was in the domestic market, and NIS 20.7 billion abroad.

Debt Management and Deficit Financing

Debt Management and Deficit Financing

Table C-9
Financing of the Government deficit in 2003
(in NIS billions)

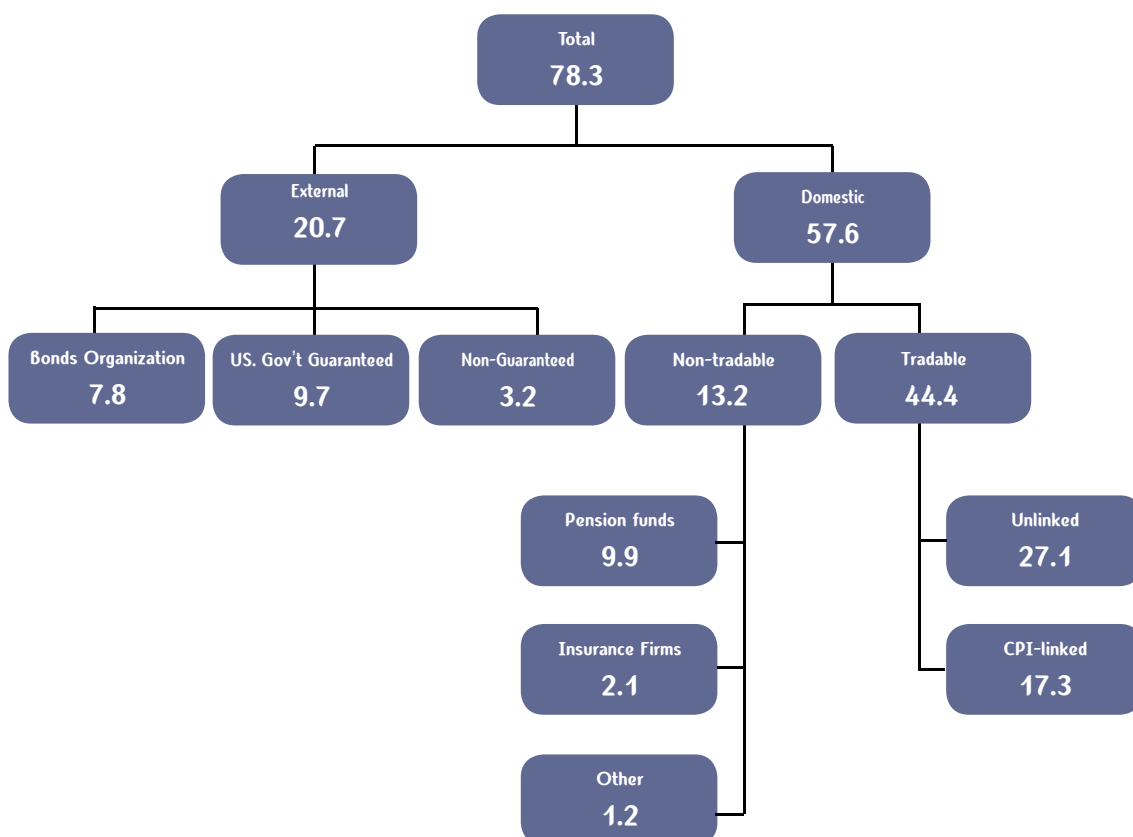
	Budget Law	Actual
Total deficit (excluding credit)	15.2	27.7
Domestic deficit	11.6	26.6
Deficit abroad	3.6	1.1
Income	197.6	174.9
Of which:		
Domestic	182.2	162.2
Abroad	15.4	12.7
Expenses and credit granted	213.0	200.8
Of which:		
Domestic	194.0	187.1
Abroad	19.0	13.6
Total financing	15.3	25.9
Foreign financing (net)		6.7
Capital raised ⁽¹⁾	16.9	20.7
Redemption of principal	16.9	14.0
Domestic financing (net)	13.9	22.5
Capital raised	52.2	57.6
Redemption of principal	38.3	35.1
Capital income (privatization)	1.5	0.3
Change in balances (reserves)	0.0	-3.6

Source: Accountant General Division, Ministry of Finance

3. Government Funding

Government funding is divided into domestic and external funding. Funding in the different channels (adjusted for the end of 2003) is presented in diagram C-10.

Diagram C-10: Funding distribution in 2003
(NIS billions)



Source: Government Debt Management Unit, Ministry of Finance

This chapter will detail funding by the Government in 2003, in the domestic market and abroad, in both tradable and non-tradable channels.

D. Domestic Funding

● Tradable funding

Despite the increase in the deficit and in financing needs, domestic tradable funding needs decreased slightly relative to the previous year, totaling NIS 44.4 billion in 2003. The key reason for the decrease was the opening of the U.S. Government guaranteed funding channel. Domestic tradable funding through unlinked (fixed interest) 'Shahar' bonds totaled NIS 18.6 billion; funding through unlinked (floating interest) 'New Gilon' bonds totaled NIS 8.5 billion; and funding through CPI-linked 'Galil' bonds totaled NIS 17.3 billion in 2003.

Debt Management and Deficit Financing

Debt Management and Deficit Financing

Table C-10

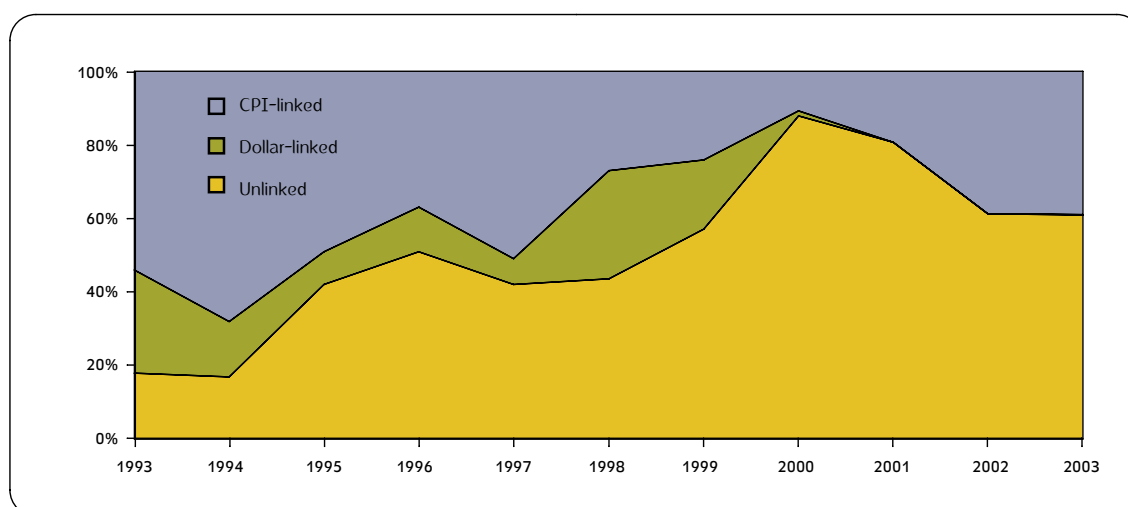
Capital raising and redemptions of principal in the tradable bonds market in 2003

	Issuance		Redemptions		Net funding
	NIS millions	% of total	NIS millions	% of total	NIS millions
Shahar	18,591	41.9	2,550	10.2	16,041
New Gillon	8,470	19.1	0	0	8,470
Total unlinked	27,496	61.0	2,550	10.2	24,946
Galil	17,317	39.0	6,404	25.6	10,913
Sagi	0	0	5,005	20.0	-5,005
Kfir	0	0	2,297	9.2	-2,297
Total CPI-linked	17,317	39.0	13,706	54.8	3,611
Gilboa	0	0	8,759	35.0	-8,759
Total USD-linked	0	0	8,759	35.0	-8,759
Total	44,378	100.0	25,015	100.0	19,363

Source: Bank of Israel

In 2003, the Debt Management Unit maintained the funding mix of CPI-linked and unlinked channels at 39% and 61%, respectively, similar to that of 2002. The share of CPI-linked funding in 2003 was significantly larger than in 2000 and 2001.

Diagram C-11: Distribution of domestic tradable funding in the different channels, 1993-2003 (percent)



Source: Government Debt Management Unit, Ministry of Finance

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In the last three quarters of 2002, the Debt Management Unit increased its funding through medium- and short-term bonds, at the expense of long-term bonds, in response to the increase in yields. This development constituted a temporary deviation from the Unit's long-term policy; as yields fell in 2003, the Unit again extended the terms to maturity of capital raised. As shown in Table C-11, the share of unlinked 'Shahar' type medium-term (7 year) and long-term (10 year) bonds grew, while the share of short-term (3-5 year) 'Shahar' bonds decreased. Concurrently, the share of long-term CPI-linked 'Galil' bonds increased, at the expense of medium-term (10 year) 'Galil' bonds. Also, note that the term to maturity of capital raised through unlinked floating-interest 'New Gilon' bonds was shortened during 2003, from ten years to four years; however, this was done for technical reasons related to the State's debt amortization schedule. Furthermore, it is important to remember that the duration of a floating-interest bond is defined as the time until the next interest payment, so that shortening the term to maturity of these bonds has a minor effect on the overall duration of the debt.

Table C-11
Tradable funding by the Government in the domestic market,
by term to maturity and bond type, 2001-2003

Bond	Years to maturity	2001 (percent)	2002 (percent)	2003 (percent)
Shahar	3-5	26.2	23.2	13.0
	7	13.0	7.6	16.5
	10	10.1	6.5	12.4
	Total	49.4	37.3	41.9
Gillon	4	0.0	0.0	19.1
	10	31.3	23.9	0.0
	Total	31.3	23.9	19.1
Galil	5	0.0	10.8	10.9
	10	6.7	21.9	13.2
	12-20	12.6	6.1	14.9
	Total	19.3	38.8	39.0

Source: Government Debt Management Unit, Ministry of Finance

● Non-Tradable Funding

Non-tradable funding in 2003 was based mainly on issues of CPI-linked 'Miron' and 'Arad' non-tradable bonds to pension funds, and on issues of CPI-linked 'Chetz' type bonds to insurance companies. The remainder of non-tradable funding was comprised of deposits with the Accountant General at the Ministry of Finance. In 2003, non-tradable capital in the amount of approximately NIS 13.2 billion was raised (23.0% of total domestic funding), of which NIS 12.0 billion was issued to pension funds and insurance companies (see Table C-12 below).

Table C-12
Funding and redemptions of principal of non-tradable debt in 2003

Funding channel	Gross funding		Redemptions of principal		Net funding
	In NIS millions	In % of total	In NIS millions	In % of total	In NIS millions
Miron	6,851	51.7	4,608	47.1	2,243
Arad	3,053	23.1	0	0	3,053
Chetz	2,102	15.9	2,134	21.8	-32
Accountant General Deposits	1,237	9.3	3,038	31.1	-1,801
Total	13,243	100.0	9,780	100.0	3,463

Source: Bank of Israel, and processing by the Debt Management Unit

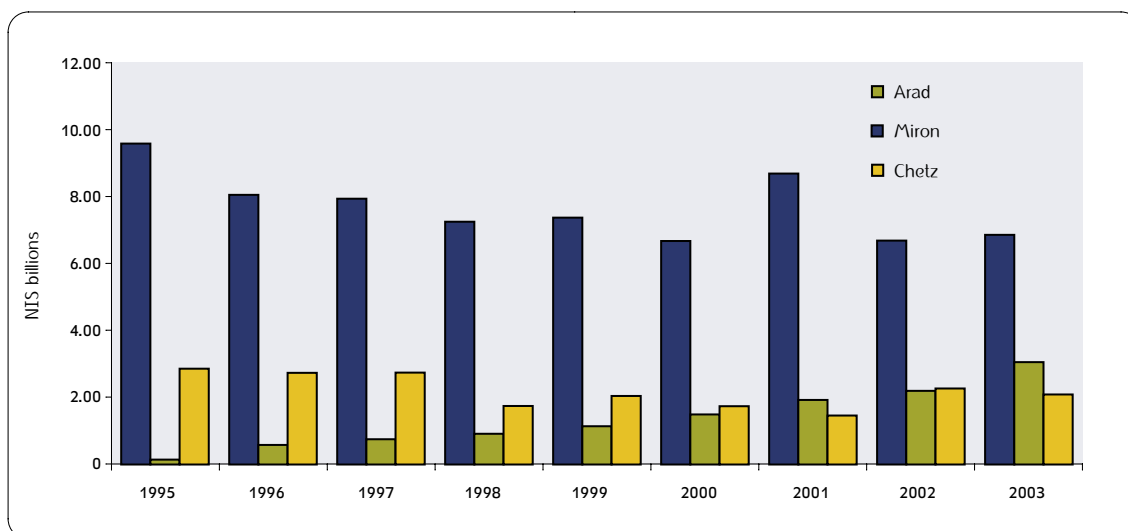
Non-tradable funding is characterized by the fact that it is not initiated by the State, but rather by the insurance companies and pension funds, due to the commitments undertaken by the State to fund members and insured clients; the Government has no control over its volume. The volume of deposits with the Accountant General is relatively small, and decreasing over the years.

The implementation of the regulations concerning the reform in pension funds during 2003 led to increased capital raising by the 'old' pension funds, in order to take advantage of the preferential terms of nontradable bonds before the new regulations came into force. In the first eight months of the year, the 'old' pension funds purchased nontradable 'Miron' bonds at a volume of NIS 6.9 billion, compared to NIS 6.7 billion in the whole of 2002. The ability of the 'old' pension funds to step up capital raising resulted from the fact that they were allowed to invest between 93% and 100% of their assets in nontradable bonds, at their discretion. By selling various liquid assets, these entities were able to purchase nontradable bonds in amounts exceeding their net inflow of funds. In contrast, the investment regulations for the 'new' pension funds stipulated that exactly 70% of their assets would be invested in nontradable bonds, so that they were unable to

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purchase nontradable bonds at a volume exceeding their net inflow of funds. In 2003, the new pension funds purchased 'Arad' type nontradable bonds at a volume of NIS 3.1 billion – some 39% more than in 2002. The growth in the volume of purchases resulted from the increased number of members in the new pension funds, a trend which gradually makes these funds a sector of increasing importance.

Diagram C-12: Composition of non-tradable funding, 1995-2003



Source: Bank of Israel

Non-tradable funding by insurance companies, via 'Chetz' bonds, totaled NIS 2.1 billion. 'Chetz' bonds are issued at interest rates ranging from 4.0% to 6.2%. The gross amount of capital raised comes mainly from principal redemptions and interest payments.

In 2003, approximately NIS 1,237 million were raised via deposits with the Accountant General ("emissions" and miscellaneous).

E. External Funding

● Funding by the Government Abroad Through Non-Guaranteed Public Issues

In June 2003, the Government of Israel issued ten-year dollar bonds at a volume of \$750 million, at a yield margin of 1.53% (153 basis points) over 10-year Treasury Bills. This was the Israeli Government's largest independent issue to date. The issue was planned at a volume of \$500 million, but in light of the high demand, which reached NIS 2 billion within 48 hours of marketing, the decision was made to increase the issue to \$750 million.

The issue was led by Lehman Brothers and Citigroup, which were given the mandate for the issue in August 2001 (about one month before the September 11 attacks). The timing of the issue was selected following the successful conclusion of the military campaign in Iraq, the guarantees

granted by the U.S. Government and the agreement between Israel, the United States, and the Palestinian Authority under Abu Mazen with regard to the Road Map.

Issues by other countries with similar ratings, such as South Africa (Baa/BBB) and South Korea (A-/2A) in the weeks preceding the Israeli issue contributed to the pricing obtained by the Israeli Government, after a 3-year absence from the dollar bonds market.

The timing of the issue was highly successful in terms of market conditions, due to the large demands in the bonds market at the time, as well as the extremely low level of interest rates (a 40-year low) at the date of the issue (see Diagram B-10).

The issue achieved its strategic goals, and repositioned Israel's risk premium abroad. The number and diversity of investors were unprecedented for an issue by the Israeli Government. The continued contraction of the spread in the secondary market in the months following the issue, to some 100 basis points above the U.S. Government, expresses the continuing demand for Israeli Government bonds, and for the Israeli "brand" in general.

In the beginning of 2004, the Government executed an additional issue at a volume of \$500 million, for a ten-year period. The issue was performed at a margin of 115 basis points (1.15%) over the U.S. Government yield, the lowest margin obtained by Israel for a comparable issue since 1995, and some 40 basis points lower than the previous issue. The underwriters for this issue were Citigroup and UBS.

Public Issues Backed by U.S. Government Guarantees

In 2003, three issues were carried out, at a total volume of \$2,350 million, of which \$450 million were for 30 years and \$1.9 billion were for 20 years. The U.S. Government deducted \$289.5 million from the framework of guarantees, for the Government's civilian investments in the Territories. Thus, an additional \$360.5 million can be used in any year from 2004 to 2006. A commission is paid for the guarantee, out of the proceeds of the issue, to the Federal Agency for International Development (A.I.D.), which guarantees the bond issues. This year, the commission amounted to approximately \$154.9 million. Note that the commission for the second issue was significantly lower than the commission for the first issue (4.96% for 20 years in the second issue, versus 7% for 20 years and 8.27% for 30 years in the first issues). The guarantees were issued via a competitive bid among the world's fourteen largest investment houses. In this issuance method, each bank submits a proposal for the purchase of all issued bonds, and the bank that submits the proposal in which the yield to the issuer is lowest wins the bid and purchases the full amount of bonds offered.

In the first issue, the investment bank Barclays won the bonds issued for thirty years, while Merrill Lynch won the bonds issued for twenty years. The investment bank Lehman Brothers won the second issue.

The issues were carried out through an Internet website constructed by the Ministry of Finance specifically for this purpose. The website was open to participants for fifteen minutes, until the bid

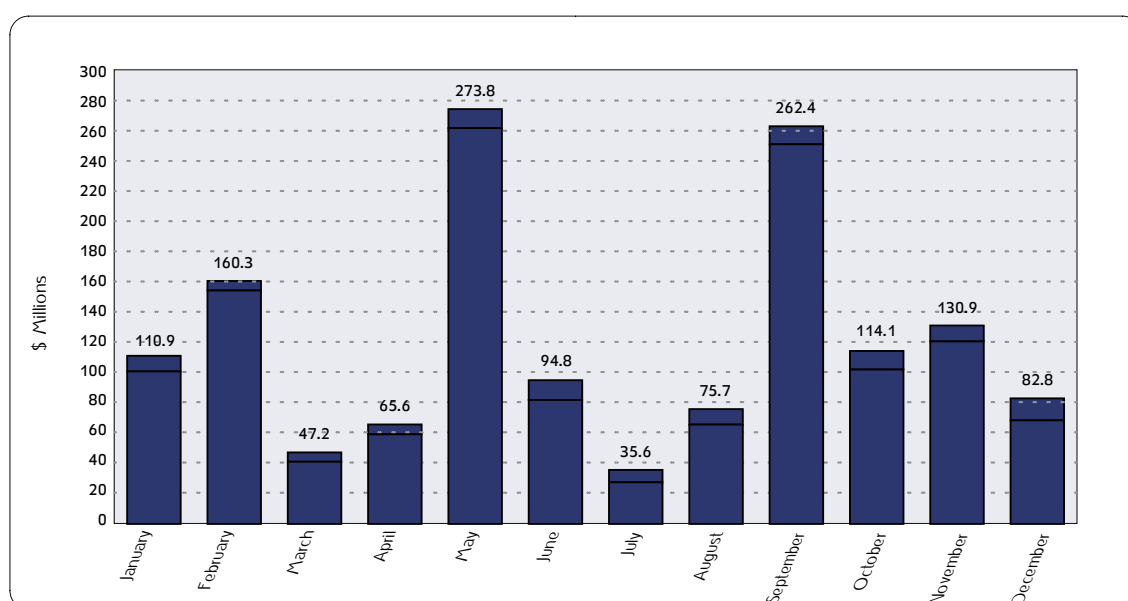
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was closed. After the results were approved by the A.I.D., they were presented to the winning bank and to the other banks within several minutes.

Summary of Funding by the Bonds Organization in 2003

In 2003, the Bonds Organization recorded a 13% increase in the volume of annual sales, which reached \$1,454 million, compared to \$1,284 million in 2002. This amount was 16% higher than the target set by the Accountant General at the beginning of the year (\$1,250 million).

Diagram C-13: Monthly sales volumes of the Bonds Organization in 2003



Source: Government Debt Management Unit, Ministry of Finance

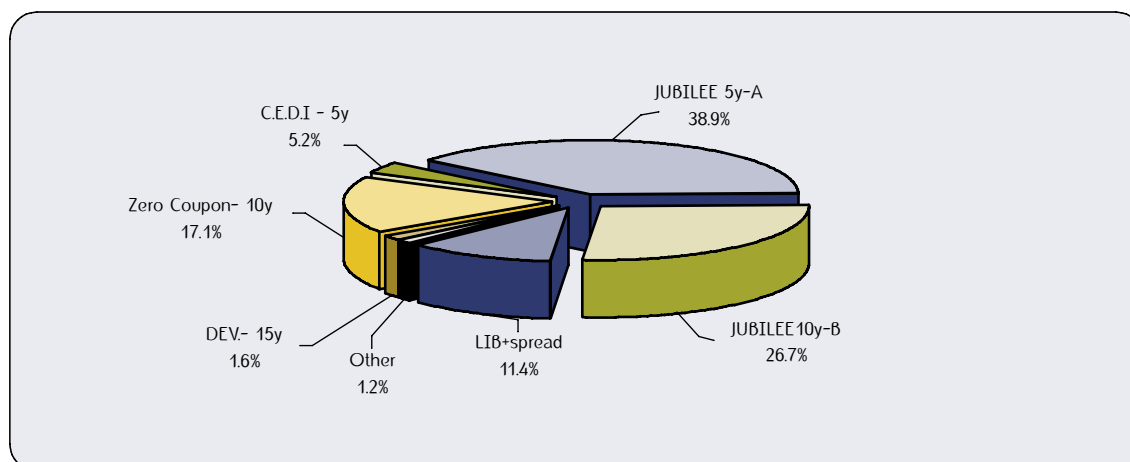
In 2003, approximately 89% of the capital raised by the Organization was at fixed interest (see detailed information regarding Bonds Organization funding instruments in Annex D). This distribution was to be expected, in view of the low level of LIBOR interest rates in the markets during 2003. For comparison, recall that in 2002 (which was characterized by a sharp decline in interest rates) there was a similar distribution (approximately 85% of capital raised was at fixed interest), while in 2001, only 62% of the Organization's sales were in fixed-interest bonds.

The trend of extending the debt's term to maturity continued in 2003; the average term to maturity of bonds rose to 7.6 years (excluding early redemption), compared to 7.3 years in 2002. This increase is in line with the policy aimed at extending the debt repayment period.

Debt Management and Deficit Financing

Debt Management and Deficit Financing

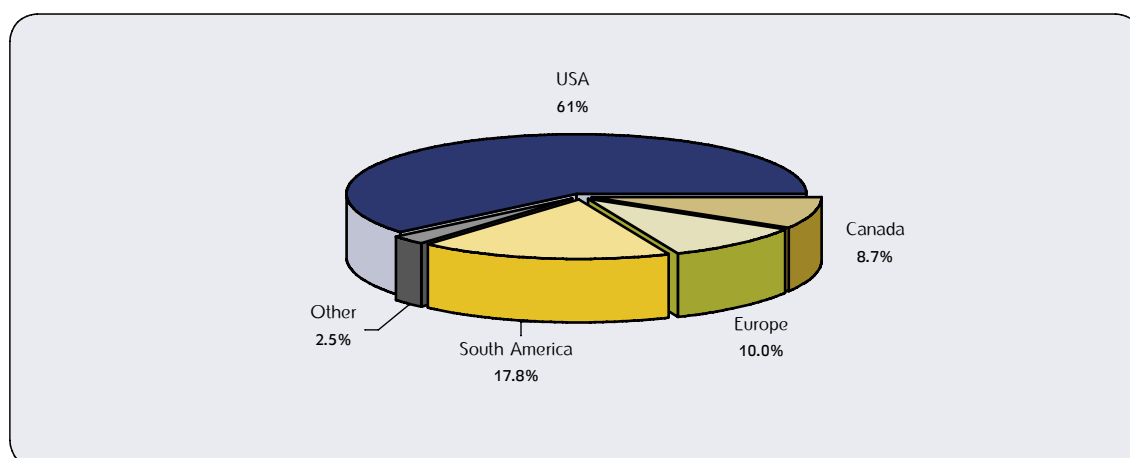
Diagram C-14: Distribution of the Bonds Organization's sales by funding instruments in 2003



Source: Government Debt Management Unit, Ministry of Finance

In 2003, the share of sales in the United States out of total sales by the Bonds Organization grew to 61% (compared to 50% in 2002 and 47% in 2001). The volume of sales in Latin America also increased somewhat in 2003, to 18% (compared to 17% in 2002). Conversely, the share of Bonds Organization sales in Europe and Canada decreased in 2003, to 10% and 9% (respectively), compared with 21% and 11% in 2002. The share of Europe is the lowest in the last five years. The drop in sales to Europe may be accounted for by the weakening of the American dollar against the Euro. The Bonds Organization does not have bonds denominated in Euro, so that investors in Europe may have preferred not to purchase the Organization's dollar bonds, focusing on Euro-linked channels instead.

Diagram C-15: Geographic distribution of sales by the Bonds Organization in 2003



Source: Government Debt Management Unit, Ministry of Finance

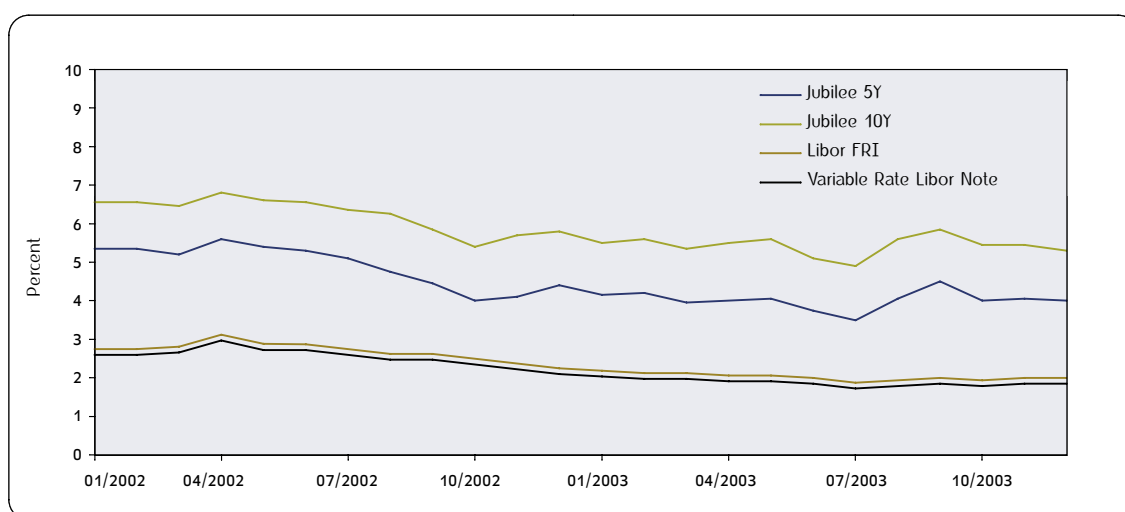
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Five and ten-year 'Jubilee' bonds accounted for 66% of the Organization's sales in 2003 (five-year bonds: 39%, ten-year bonds: 27% of total sales), similarly to the situation in the past two years. An examination of the absolute values of these sales shows that ten- and five-year Jubilee bonds are among the few bonds whose sales increased relative to 2002 (by 17% and 6%, respectively). Note that in terms of currency distribution, 95.3% of the Organization's total sales are in American dollars. The remainder of sales are in Canadian dollars (4.7%) and Pounds Sterling (0.01%). An examination of the distribution of bond sales by original term to maturity shows that 49% of the Organization's total sales were of bonds with an original term to maturity of five years, while 47% of sales were of bonds with an original term to maturity of ten years.

The interest rates paid by the Organization were quite high in the first half of the year (the ten-year Jubilee bond was sold at an average margin of 170 bp over the TB10y, and the five-year bond was sold at an average spread of 130 bp over the TB5y), in accordance with the high risk premium assigned to Israel at that time. At the end of June, following the successful global issue, the yields generated by the Bonds Organization's various bonds were adjusted to the margins in the secondary market of Israel's independent issue (\$750M): the ten-year Jubilee bond was sold at an average margin of 125 bp over the TB10y, and the five-year bond was sold at an average margin of 95 bp over the TB5y.

The cost of funding in foreign currency through the Bonds Organization, from the point of view of the issuer (i.e. the State of Israel), including the cost of the Organization's budget and additional costs incidental to issuing the bonds, amounted to 5.31% in 2003, of which 59 basis points were due to the Organization's administrative (not financial) costs.

Diagram C-16: Development of the yield to investors in selected bonds of the Bonds Organization in 2002-2003



Over the last two years, the Ministry of Finance has implemented an extensive series of reforms aimed at enhancing the efficiency of public expenditure and increasing competition in the economy. This policy is based on the understanding that there is a negative correlation between public expenditure and growth in Israel. Today, it is clear to everyone that without a significant, consistent reduction of the burden of public expenditure on the Israeli economy, it will not be possible to lessen the tax burden and release resources towards growth in the private sector.

Yet, the reforms have hitherto applied only to some 80% of the State budget. A sizable and significant segment of approximately NIS 35 billion in interest expenses remained without fundamental treatment. As a result, the importance of implementing the primary dealers reform has progressively increased. This reform has been adopted in most advanced economies, and studies show that it has led to significant reductions in funding costs of governments, decreases in long-term interest rates, increased competition, transparency, financial stability, and active participation of foreign investors in domestic markets.

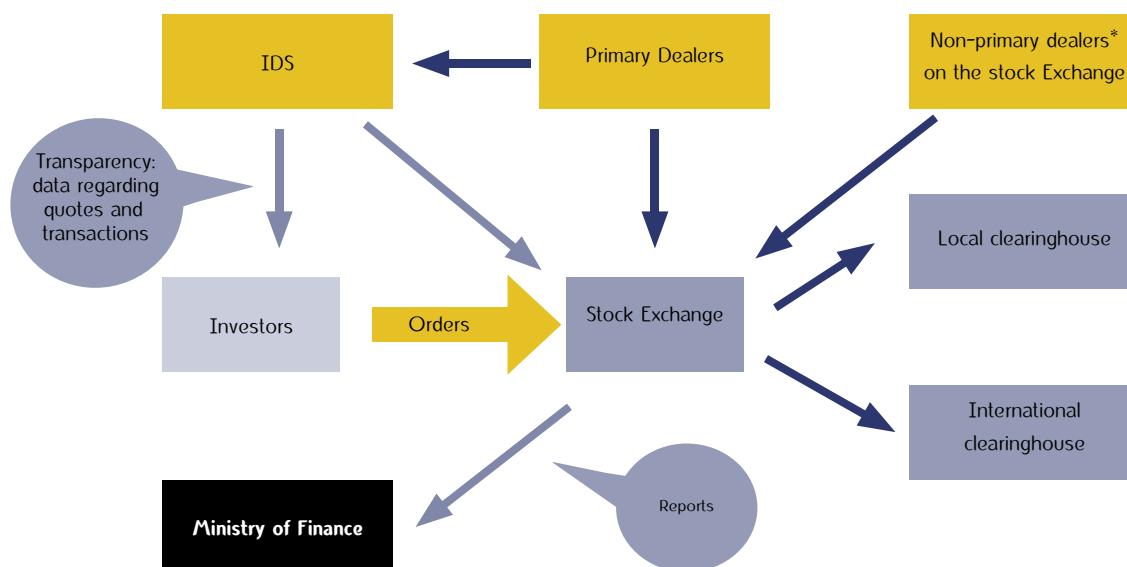
For these reasons, and in order to encourage liquidity in the secondary market and reduce funding costs, in recent years the Debt Management Unit has been promoting a comprehensive reform in the Government bonds market, by adapting models used abroad to the conditions and needs of the domestic market.

Concurrently with the introduction of primary dealers, the Ministry of Finance intends to contact institutional entities in Israel and abroad, and invite them to participate directly in bond auctions that are open to the public. Exposure to competition from international entities will enhance the sophistication of the bonds market, lead to a greater variety of financial instruments, and raise the quality of services provided to customers. Additionally, such exposure is expected to lead, eventually, to an increase in the profitability of local financial entities, as was the case on other occasions when the economy was exposed to international competition.

The experience of other countries in which similar reforms were carried out indicates that the trading volumes (the 'liquidity') of Government bonds rose dramatically in the years following the implementation of the reform.

The Ministry of Finance has been promoting the subject of market making in the Government bonds market since 2001. Moreover, in 2001, an inter-ministerial committee was established, which included representatives of the Ministry of Finance, the Bank of Israel, the Israel Securities Authority, and the Tel Aviv Stock Exchange. The committee submitted its recommendations on this matter at the end of 2002, and the model currently proposed by the Ministry of Finance includes the implementation of a majority of these recommendations.

Diagram D-1: New structure of the Government bonds market



* To be appointed by the TASE, operating according to its regulations.

1. Primary Dealers

Primary dealers are large, stable financial institutions that sign an agreement with the Ministry of Finance, according to which they commit to operate in the primary and secondary markets.

Primary dealers will commit to a minimal volume of activity (an annual volume of bond purchases) in Government bond auctions. In addition, they will commit to quoting buy and sell prices for large series of Government bonds, in a new trading system which is to be established (the IDS – Inter-Dealer System), for several hours daily, at maximum spreads. In return, the majority of bonds sold in auctions of non-linked ('Shahar') bonds will be reserved for all of the primary dealers, in the first stage of the reform. At this stage, there will be no such reservation in auctions of FRNs ('New Gilon') and CPI-linked ('Galil') bonds. Further, primary dealers will enjoy the option of an additional allocation at the average price of the auction, on the day following the auction, access to the repo facility being established by the Ministry of Finance, in collaboration with the TASE Clearinghouse, and exclusive access to the new designated trading system (the IDS). In addition, primary dealership will be taken into account in selecting partners for the Government's financial transactions in Israel and abroad. Quotes on the IDS will be transparent to the entire market, and will therefore become an important benchmark for efficient pricing in the bonds market.

2. Market Makers in the Tel-Aviv Stock Exchange

Market makers on the stock exchange are exchange members who will commit to quote on the Tel Aviv Stock Exchange, in accordance with the recommendations of the inter-ministerial committee on market making on the stock exchange (the Hauser Committee). The TASE will stipulate, in its regulations, the terms under which the market makers on the stock exchange will operate. In addition to the compensation received by these market makers from the stock exchange (such as reduced commissions), the Ministry of Finance may compensate them via a mechanism of over-allotment in bond auctions in which they participate.

In this way, relatively small financial entities will also be able to participate as market makers without taking upon themselves commitments that require capital and risk management capabilities which they do not have. This distinction between primary dealers and market makers on the TASE is common worldwide.

3. The Bonds Repo Mechanism

Primary dealers will be obligated to quote buying and selling prices (bids and offers) of bonds continuously. This exposes them to the risk that they will not be able to deliver the bonds if there is insufficient liquidity in the market.

Repo in Israel is in its early stages as a result of economic and legal obstacles. The relevant government agencies have been working to resolve the problems and the Bank of Israel has been promoting a real-time clearing system — RTGS (Real Time Gross Settlement), which is planned for completion within two or three years.

In order to enable the primary dealers to undertake the quoting commitments, the Ministry of Finance will establish a repo facility for the primary dealers, through the TASE Clearinghouse. A primary dealer needing a bond will borrow it from the TASE Clearinghouse. In exchange, it will transfer cash (for which it will receive interest), or securities, as a guarantee. It is hoped that the existence of the facility will serve as an incentive to the development of an active repo market, concurrently with the removal of the economic and legal barriers which are delaying it at present.

If an active, liquid, repo market does develop, it may be possible to gradually phase out the repo facility.

4. Technical Preparations

A New International Trading System

In 2003, the Debt Management Unit continued working on the preparation of a technological infrastructure for bond issues and trading. MTS, the leading European company in the development of infrastructures for wholesale (inter-dealer) trading in Government bonds, was selected to develop the primary dealers' trading system, in collaboration with the TASE. The use of the MTS system for trading in Israeli Government bonds will allow traders and investors operating abroad to trade continuously, in real time, in the domestic bonds market, without the need for actual presence in Israel. The system will also allow domestic primary dealers direct access to the European bonds market.

A New International Auctions System

The Debt Management Unit is in contact with Bloomberg, working to adapt its auctions system to issues of Government bonds. Bloomberg's issuance system is simple to operate, highly reliable, and functions successfully in a large number of countries, including Belgium, Ireland, and South Africa. The system will enable market makers to participate in Government auctions from abroad as well, in a simple, inexpensive, and transparent manner.

5. Legislation

The Debt Management Unit is in the process of carrying out several necessary changes in the State Loan Law and in the regulations of the Law. The major changes are:

- **Changing the names of bonds** – the bond names 'Shahar', 'Gilon', and 'Galil' will be changed to 'fixed-interest Government bonds', 'floating-interest Government bonds', and 'linked Government bonds' (respectively), as is common practice elsewhere in the world.
- **Changing the underlying asset of the 'New Gilon'** – the underlying asset of this bond, which is currently the average yield of a number of Makams at terms to maturity of 3-12 months, will be replaced by the yield of a specific Makam, at the term to maturity closest to three months. This is in order to facilitate hedging via the bond.
- **Canceling the physical issuance of bonds** – no certificates are to be produced for the bonds issued, as physical issuance of bonds is no longer commonly practiced, and is cumbersome and superfluous to both the Government and the purchasers.
- **Publishing over the Internet** – the terms of each bond series will be published on the Government's website, rather than in two widely circulated daily newspapers, as required under the current law.

Part D

The Reform in the Government Bonds Market

The Reform in the Government Bonds Market

- **Canceling the ceiling for total domestic Government debt** – the ceiling which has hitherto applied to the balance of debt (the volume of bonds issued under the State Loan Law) will be canceled, since this cap has been ineffective for several years.
- **Additional changes** – simplifying and standardizing the regulations, adopting international standards, allowing extensions of the ranges of issues, and regulating the matter of "ex" dates.

In December 2004, the Israeli Parliament approved the amendment of the State Loans Law.

The Debt Management Unit has initiated and is fully involved in legislative amendments in two additional areas:

- **Exemption from deduction of withholding tax on interest payments for foreign investors** – as is the common practice abroad, in order to encourage the entry of foreign investors into the bonds market, the Debt Management Unit and the Tax Authority have promoted legislation which would grant an exemption from withholding tax on interest payments for foreign investors. In September 2004, the Knesset Economic Committee approved the exemption retroactively from January 2004.
- **Promoting a new law regarding special transactions in securities** – the Debt Management Unit, together with the Bank of Israel, the Ministry of Justice, the Capital Market Division, and the Israel Securities Authority, are working to promote the legislation of a new law regarding special transactions in securities, dealing with repo transactions, which would enable the development of this essential market in Israel, as well as with the status of other transactions (spot transactions, future transactions, and derivative transactions) in the inter-bank market, which require the possibility of netting between opposite transactions. The law would define, among other things, the legal status of the asset, and would clarify the issue of its ownership in cases in which one of the parties enters a process of liquidation or bankruptcy during the transaction. A liquid repo market will assist in the development of a non-bank credit market, thereby lowering financing costs in the business sector.

6. Expected Benefits of the Reform in the Government Bonds Market

The advantages of the proposed reform may be summarized as follows:

- **Large savings in funding costs for the Government and the private sector** – the reform will increase competition in the primary market and liquidity in the secondary market. As a result, the Government's funding costs are expected to decrease, along with the funding costs of the business sector and the interest payments of households.



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- **Globalization and upgrade of the financial markets** – the introduction of foreign financial entities and the transition to issuance and trading via international electronic systems will deepen the integration of the domestic Government bonds market, and the capital market in general, with the international markets.
- **Less concentration** – the entry of large international financial entities into the primary and secondary markets will increase competition in the Government bonds market.
- **A trigger for the expansion of activities of foreign banks and institutional investors in the Israeli capital market** – international financial entities that join the system as primary dealers are expected not to be involved only in activities in the Government bonds market, but to operate in other sectors of the capital market as well. Thus, the reform in the Government bonds market is a complementary measure in line with other actions taken by the Ministry of Finance to enhance the sophistication of the Israeli capital market.⁷
- **Enlarging the base of investors in Government bonds** – the entry of globally deployed financial entities undertaking a commitment to continuous activity in the Israeli capital market will facilitate the distribution of Israeli Government bonds to institutional and private investors abroad, to whom access is currently limited, thereby widening the circle of investors in Government bonds.
- **Transparency of large bonds transactions** – the transition to a designated bond trading system will increase “market depth” and transparency, particularly with regard to large transactions, which are currently executed primarily by telephone, and are therefore not transparent.
- **Adoption of international standards** – the reform includes the adoption of international standards of trading and clearing.
- **Development of new financial instruments** – the activity of knowledgeable, experienced primary dealers will aid the development of financial instruments that do not currently exist in the Israeli capital markets, such as swap contracts, repos, Commercial papers (CDs) and bond derivatives, commercial securities, etc.

⁷ Indeed, Deutsche Bank has recently joined the TASE, and additional foreign international banks are similarly considering membership in the Exchange and in the Clearinghouse. Furthermore, the international investment bank Bear Stearns has recently joined the insurance company Migdal in the ownership of the Exchange member Migdal Capital Markets.

7. Estimated Timetable of the Reform

■ 2004:

1. Amendment of the State Loan Law – in a manner that authorizes the Government, via the Ministry of Finance, to appoint primary dealers.
2. Granting an exemption from tax on both capital gains and interest from Government bonds to foreign investors.
3. Formulation of an advanced draft of the Special Transactions in Securities Law.

■ First Half 2005:

1. Publication of the RFP for primary dealers.
2. Approval of State Loan regulations.
3. Continued technical preparations – Bloomberg, MTS, repo facility, monitoring and reporting systems.
4. Selection and appointment of primary dealers.
5. Completion of the Special Transactions in Securities Law.

■ Second Half 2005:

1. Conclusion of technical preparations.
2. Conclusion of the transition of the Debt Administration from the Bank of Israel to the Ministry of Finance.
3. Final tests.
4. Implementation of the reform.

Part E

The State's Credit Rating and the Improvements in the Government's Domestic Bonds Auctions

1. Improvements in the Government's Domestic Bonds Auctions

As part of the efforts to improve the efficiency and sophistication of the Government bonds market, the Debt Management Unit introduced two important changes to the auctions in April 2003:

A. Minimum Price

The minimum price is the lowest price at which auction bids are accepted. Offers below this price are disqualified and are not considered, regardless of the amount sold in the auction. Prior to the change, the minimum price was equal to the closing price at the end of trading three days before the auction date, minus 7%, or the number of years to maturity, whichever was higher. The minimum price was announced two days before the auction.

The mechanism described above had several flaws:

- The minimum price was determined by market prices a relatively long time before the auction and therefore did not reflect the market price at the time of the auction.
- The large gap between the market price and the minimum price rendered it ineffective, and did not prevent sales of bonds even when the prices offered by them were very low.
- In certain cases, the fact that buyers knew the minimum price created an incentive to lower the prices offered by them towards the minimum price.

In light of the above, a decision was made to change the method of determining the minimum price. The minimum price of an issue is now determined minutes before the auction opens, based on the average prices on the secondary market in the days preceding the auction. This method maintains a far lower difference between the minimum price and market prices. Additionally, the minimum price is not disclosed.

B. Additional Allocations of Bonds at the Closing Price

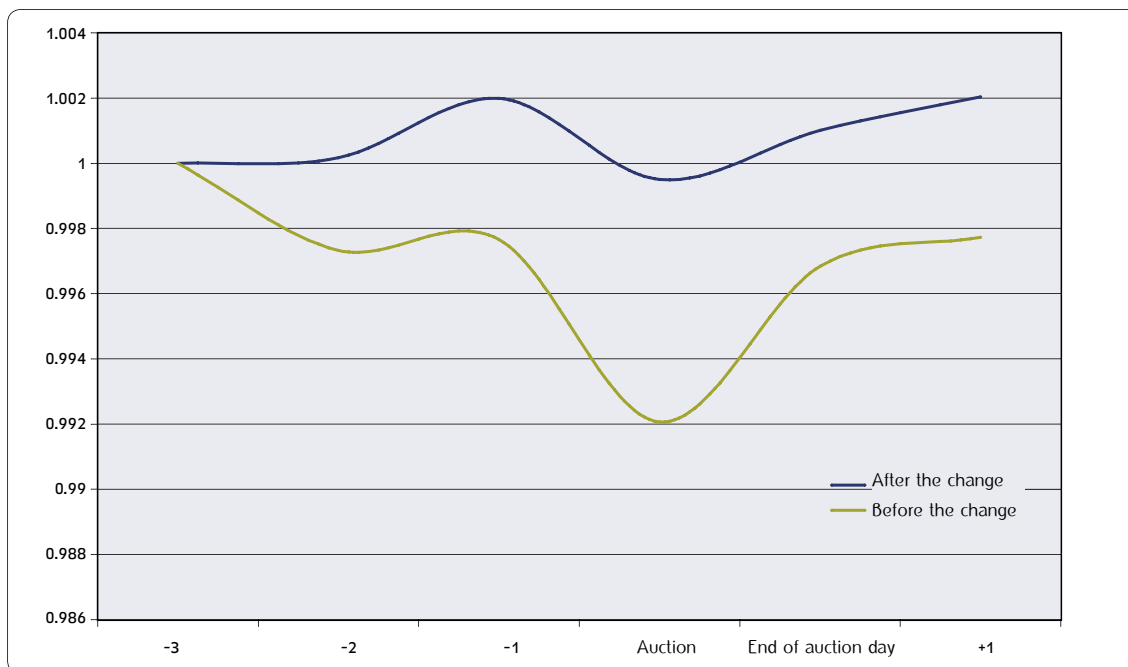
The rules for auctions were amended so that in case of excess demand at the closing price an additional sale of bonds at that price is carried out automatically, up to 20% of the amount announced, provided that the closing price is not lower than the average price of the auction (prior to the sale of the additional amount) by more than NIS 0.20.

These parameters (which can be changed) are published in advance of each auction, in the Bank of Israel's routine issuance circulars.

Benefits of the Changes

Diagram E-1 shows the trajectory of the development in prices before and after our auctions in the twelve months prior to the change and in the ten months since the new tender rules were implemented. For the purpose of illustration, the diagram shows CPI-linked bonds and unlinked bonds bearing fixed interest, at the longest terms to maturity (series 5903, 2681, and 2680). The prices displayed are end-of-day prices on the three days preceding the auction, on the day of the auction, and on the day following the auction, as well as the closing price of the auction. Prices are normalized relative to the closing three days before the auction date (-3). As shown, in the period before the change, the closing price was on average 0.8% lower than the closing price three days before the auction, and the closing price at the end of the auction day was 0.5% higher than the closing price. After the change, the closing price was only 0.05% lower than the closing price three days before the auction, and the closing price at the end of the auction day was only 0.15% higher than the closing price. One of the main reasons for the decrease in prices on the days preceding the auction and on the auction day itself was the knowledge of the minimum price in the auction. The fact that the minimum price had already been determined and published created an incentive for market participants to drive bond prices down in anticipation of the auction, with the aim of purchasing the bonds at lower prices. Moreover, the relatively large margin between the secondary market prices and the minimum price allowed for considerable price reductions without the concern that excessively low-priced offers would be disqualified. While it is difficult to isolate the change in the auctions from other factors, it is certainly possible to deduce that the non-disclosure of minimum prices and the decreased margin between the minimum price and the primary market helped to reduce the decline in primary market prices relative to the secondary market, and led to significant savings in the Government's funding costs.

Diagram E-1: Developments in a sample of normalized bond prices, before and after the change in the auction system



Source: Government Debt Management Unit

Further, the mechanism of additional allocation has led to greater flexibility and an improved ability to adjust funding volumes to market conditions. From the implementation of the change to the end of 2003, the additional amounts of bonds sold totaled a value of NIS 3.2 billion (nominal value), which constituted 13.1% of the original amount offered. The additional allocation mechanism enabled the Government to better take advantage of favorable market conditions, reduce funding costs, and supply demand.

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Table E-1
Additional and total allocations in bond auctions, 4/2003 - 12/2003

Bond name	Series	Quantity offered (NIS million)	Additional quantity (NIS million)	Quantity sold (NIS million)	Percentage of additional quantity	Average price	Closing price	Difference
New Gilon	2311	4,500	897	5,397	19.9%	98.55	98.50	0.05
	Total							
Galil	5472	565	26	591	4.6%	113.44	113.27	0.17
	5481	3,158	188	3,346	6.0%	103.25	103.00	0.25
	5501	500	82	582	16.4%	105.09	105.05	0.04
	5903	4,695	522	5,217	11.1%	100.29	100.15	0.14
	Total	8,918	818	9,736	9.2%	102.39	102.22	0.17
Shahar	2670	1,700	340	2,040	20.0%	109.98	109.92	0.06
	2671	5,479	694	6,173	12.7%	100.20	100.11	0.09
	2681	3,895	467	4,362	12.0%	115.62	115.50	0.12
	Total	11,074	1,501	12,575	13.6%	107.13	107.04	0.09
Total		24,492	3,216	27,708	13.1%	103.80	103.68	0.12

The additional allocation mechanism has also improved the internal composition of capital raising and adjusted it to the relative prices of the different bonds. In 2003, fixed-interest unlinked bonds enjoyed relatively high demand, and the relative cost of funding in these channels fell. As a result of the brisk demand for these bonds, the difference between the closing prices and the average auction price was low (an average NIS 0.05), so that the additional allocation in these auctions approached the maximum (19.9%). In contrast, the demand for CPI-linked bonds at 9 years to maturity (series 5481) and 12 years to maturity (series 5472) was relatively low, and the difference between the closing prices and the average price was relatively high, so that the additional allocation was relatively small, at 4.6% and 6.0%, respectively.

Due to the reduction of the gap between the market price and the minimum price, a partial sale of the bonds offered in an auction is not exceptional and is no longer considered to be a failure of the auction.

2. Development of the State's Credit Rating

The Israeli Government's long-term foreign currency credit rating remained unchanged in 2003, at A- according to the international rating agencies S&P and Fitch, and A2 according to Moody's.

Representatives of all three agencies visited Israel during the year in order to reassess their ratings, and each decided to maintain the existing rating. Moreover, in December 2003, Fitch decided to upgrade its 'negative' outlook with regard to the external debt, amending it to 'stable'. Moody's maintained its 'stable' forecast, while S&P maintained its 'negative' forecast, but published a highly favorable report on the Israeli economy.

The parameters which evoked particular concern in the three agencies were the dynamics of the development of the budget deficit, and the ongoing increase in the volume of public debt, a trend expected to continue in 2004 as well. Conversely, the structural reforms, the improvement in the balance of payments, the improvement in the geopolitical situation subsequent to the end of the campaign in Iraq, and, primarily, the U.S. loan guarantees program served to counterbalance the increase in the budget deficit.

The credit rating is used by investors (mainly institutional investors) as a tool enabling an assessment of the risk inherent in their investment. Most institutional investors invest their money for a relatively long period, and expect a yield that reflects the risk level of the entity to which they have loaned their money. The credit rating (in conjunction with other factors) provides them with an indication of the risk level of their investment.

In determining a country's credit rating, rating companies examine numerous parameters, in several categories: political risk, fiscal stability, fiscal flexibility, monetary stability, and external stability. On each parameter, the country in question is compared to similarly-rated countries – its reference group. Israel's reference group mainly includes medium-sized economies, most of which are peripheral European countries – Poland, Hungary, Greece, Cyprus, the Czech Republic, Estonia, Latvia, Iceland, etc., as well as Chile, Hong Kong, South Africa, Korea, and Malaysia.

The rating of the State of Israel is problematic, since the Israeli economy has contradictory characteristics. On the one hand, Israel has a developed, diverse economy, based on a developed business sector. This characteristic is reflected in Israel's high per capita GDP, which is more in line with AA rated countries such as Spain and Portugal than with countries in Israel's reference group, some of which have a per capita GDP equal to a third of Israel's, or even less. On the other hand, however, it should be noted that this high per capita GDP diminished in 2002-2003 (and has resumed its growth in 2004). In addition, the ratings of Central European countries have risen, and the yields of their bonds have declined sharply over recent years, in anticipation of their inclusion in the European Union in May 2004 and in the Euro zone in the future.

The State of Israel enjoys a developed Government bonds market, which has proved itself in recent years as a deep, tradable, liquid market. The Israeli Government possesses the ability to finance the majority of its deficit on the domestic market, without the need to rely on foreign

sources as other countries do. This characteristic is also more reminiscent of AA-rated countries than of countries in Israel's peer group, most of which have no choice but to raise capital abroad, so that their dependence on foreign investors is greater than that of Israel. In contrast, the level of Government debt (in terms of the GDP) in Israel is one of the highest among the countries rated as Investment Grade, and the budget deficit is high. These two factors bind the Government's hands, impeding its fiscal flexibility. It should be noted that if the Government debt remains at such a high level, it will continue to impede fiscal flexibility in the future, requiring ever-increasing amounts of the State budget to principal repayments and interest payments.

When rating agencies examine the net external debt of the Government and of the economy in general, they see an ongoing process of reduction in this variable, the removal of most of the barriers in the foreign currency market in recent years, and the diversification of the Israeli Government's financing sources, particularly the stable sources such as the Bonds Organization and the U.S. loan Government guarantees, which somewhat offset the Government's high ratio of debt to GDP.

The crisis in Asia has caused rating agencies to move from analyses of macro-economic variables only, to an analysis that also measures the level of economic liquidity and examines the situations in which refinancing risk may be created. As lessons are increasingly learned and applied, credit rating agencies have developed an approach that can be described as a transition from an analysis of economic balance only, to a financial analysis, first and foremost, of international liquidity considerations.

Over the years, the State of Israel has maintained conservative management of the State's obligations. The increasing accrual of reserves, as well as the diverse foreign currency sources, have led to a highly convenient maturity structure, lower than usual capital raising costs, and a diverse investor base. However, it is clear that the complex geopolitical risk negatively impacts the economy of the State of Israel.

A weighted calculation of all the parameters, and a long-term perspective, lead the credit rating agencies to grant Israel the high rating it enjoys. Credit rating agencies examine a country's credit risk from a broad viewpoint, focusing on long-term processes. Ongoing occurrences such as the inability to approve the budget for several consecutive years, the non-convergence into a descending deficit trajectory, and a rising debt to GDP ratio may indicate a long-term structural problem. The Israeli economy has faced many challenges in recent years – the Intifada, the recession in the global economy, and the crisis in the global high technology industry. Each of these in its own right would present a challenge to any developed economy, and the three simultaneously were an arduous test of the Israeli economy's resilience. The questions which credit rating agencies ask themselves are whether these factors are cyclical or permanent, and what are the long-term consequences of each of these factors for the Israeli economy, and, first and foremost, for the State of Israel's debt repayment capability.

The Debt Management Unit views the fact that we have successfully crossed 2001-2003 without a downgraded rating as a badge of honor and an expression of confidence by the credit rating companies in the Israeli economy, and in the macro-economic management of the Government in general, and the Ministry of Finance in particular.

1. The Pension Reform

In May 2003, the Knesset approved a comprehensive reform in pension funds, under which their investment terms were changed, so that the share of nontradable bonds in their portfolio would gradually decrease to 30%. In addition, 'old' pension funds will be required to invest at least 50% of their total assets in tradable Government bonds. 'New' pension funds will invest the balance of their assets similarly to the investments of provident funds and life insurance plans, with no minimum required investment in tradable Government bonds.

Under the regulations of the reform, the decrease in the share of nontradable bonds in the pension funds' portfolios will be performed gradually, in accordance with the rate of maturity of the nontradable bonds they hold. Thus, through the end of the decade, no issues of nontradable bonds to pension funds are expected. Issues will only be renewed when the share of nontradable bonds out of the pension funds' total portfolio falls below 30%.

In addition, it was decided that in the future, all pension funds would receive only 'Arad' bonds **without a discount**, i.e. at an effective interest rate of 4.86%, instead of 'Miron' bonds with an effective yield of 5.57%, which were issued to the 'old' pension funds, and 'Arad' bonds with an effective yield of 5.05%, which were issued to the 'new' pension funds, prior to the implementation of the reform.

The reform in pension funds is expected to have a decisive influence on both the primary market and the secondary market for tradable government bonds, as detailed below:

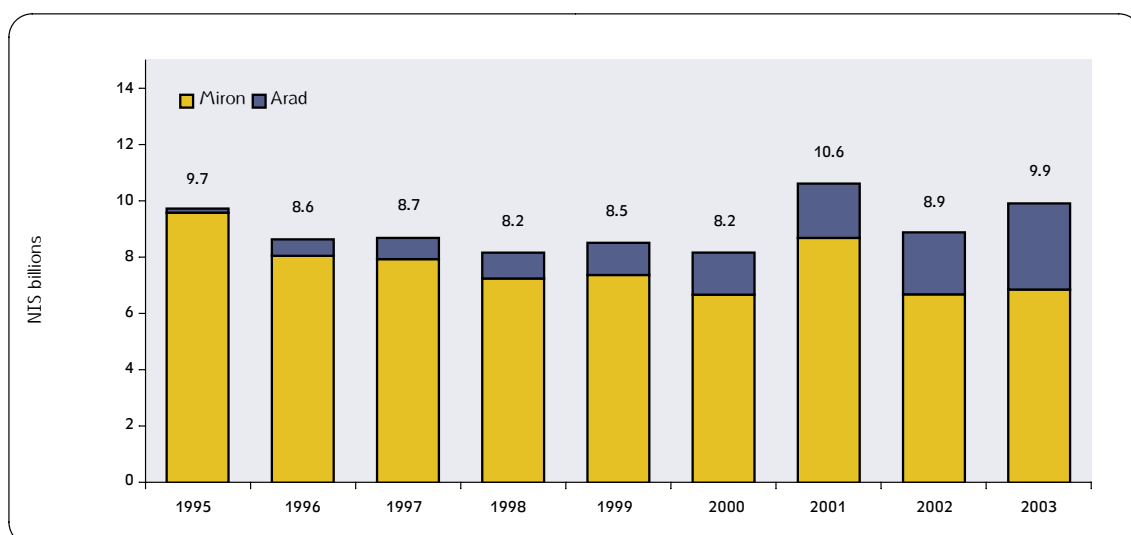
Effect of the Reform on the Primary Market

An estimate of the volume of added capital that will flow into the capital market subsequent to the reform may be obtained from the volume of sales of Government bonds to pension funds in recent years, as shown in Diagram F-1. The average volume of sales of nontradable bonds to pension funds in 1995-2003 was NIS 9.0 billion (the average amount of tradable bonds issued by the Government on the domestic market during the same period was NIS 28.6 billion).

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As shown, since the 1995 reform in pension funds, under which the new funds were created, the volume of capital raising by the 'new' pension funds has progressively grown, at the expense of the 'old' funds, which are not permitted to accept new members. However, the total amounts of capital raised remained stable, at around NIS 9 billion. In addition, the fact that in the coming years large groups of State employees are expected to transfer from budgeted pay-as-you-go pensions to private funded pensions should be taken into consideration; this will further increase the assets of the new pension funds. According to estimates by the Division of Capital Market, Insurance, and Savings at the Ministry of Finance, the average annual investments in 2004-2018 will be approximately NIS 11 billion. In the coming years, this annual amount is expected to flow into the capital market in general, and into the Government bonds market in particular, significantly expanding demand and the volume of trade. This is one of the major benefits of the reform.

**Diagram F-1: Annual sales of nontradable bonds to pension funds, 1995-2003
(NIS billions)**

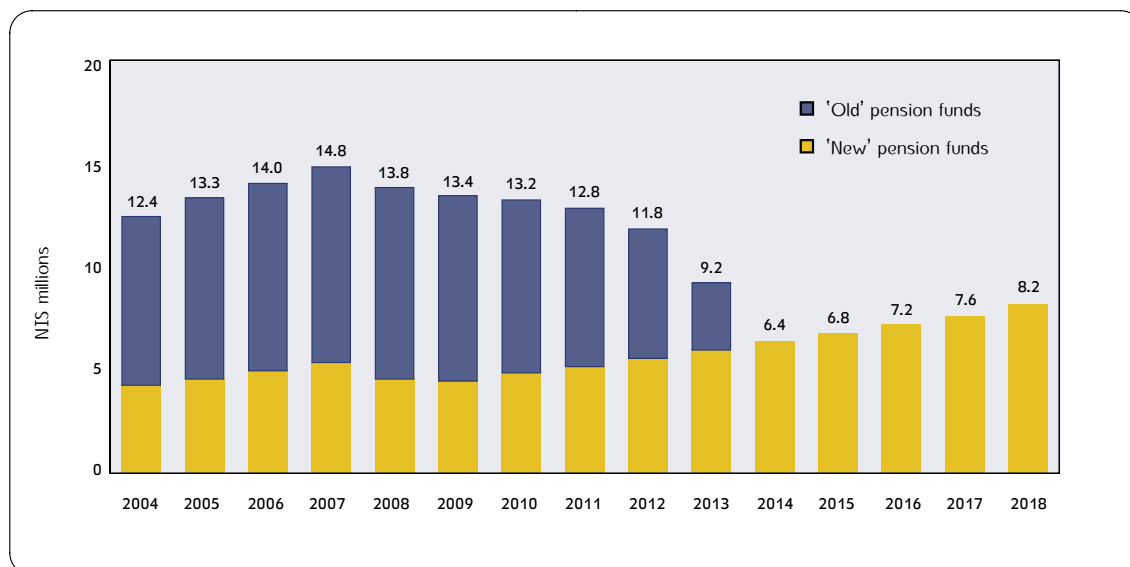


Source: Bank of Israel

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**Diagram F-2: Estimated volume of free investments by pension funds, 2004-2018
(NIS billions)**



Source: Capital Market, Insurance, and Savings Division — Ministry of Finance

The immediate effect of the approval of the reform in pension funds was increased purchases of 'Miron' bonds in July and August. The 'old' pension funds, which enjoyed the right to hold 'Miron' nontradable bonds at any amount between 93% and 100% of their portfolio, stepped up their acquisitions of nontradable bonds in the months between the approval of the reform by the Knesset and its implementation, reaching a volume of NIS 4.3 billion, and raised the weight of these bonds in their portfolios by 1.7% — from 92.0% in May, to 93.7% in August (see Table F-1). This was made possible by the sale of other assets in their possession, mainly tradable CPI-linked Government bonds, at a volume of NIS 2.4 billion. This step led to a 1.6% decrease in the weight of tradable Government bonds in their portfolio, from 2.0% to 0.4% during the period under discussion. Overall, the capital raised by the 'old' pension funds in January-August totaled NIS 6.9 billion — **NIS 200 million more than the capital they raised in this channel in all of 2002.**

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Diagram F-3: Monthly sales of nontradable bonds to the 'old' pension funds ('Miron'), 2002-2003 (NIS millions)

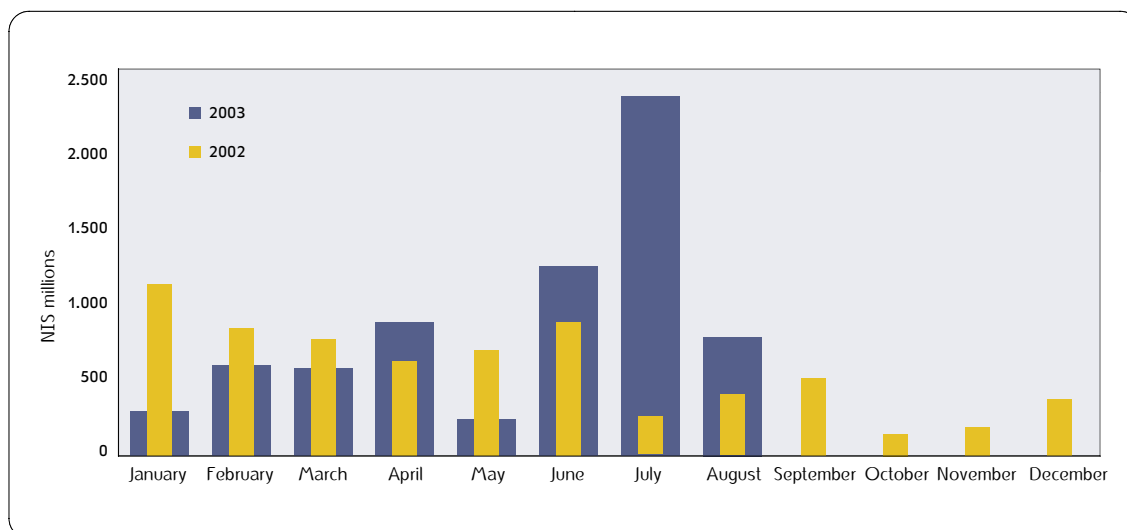


Table F-1
Distribution of the assets of "old" pension funds in 2003
(percent)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Nontradable bonds & deposits with the Accountant General	92.7	92.2	92.2	92.5	92.0	92.4	93.6	93.7	93.1	92.5	91.8	91.0
Tradable Government bonds – in Israel	2.0	2.2	2.1	2.3	2.0	0.4	0.4	0.6	0.8	1.2	1.5	1.7
Cash and deposits, up to one month, in Israel	1.5	1.5	1.6	1.0	1.5	2.7	1.4	0.8	1.0	1.0	0.9	1.2
Property rights in Israel	1.2	1.2	1.2	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.1	1.2
Equities in Israel	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.4	1.5
Non-tradable corporate bonds in Israel	0.5	0.5	0.5	0.6	0.6	0.6	0.7	0.8	0.9	1.0	1.2	1.5
Other	1.0	1.3	1.3	1.3	1.6	1.6	1.6	1.7	1.8	1.8	2.1	2.0

Source: Capital Market, Insurance, and Savings Division, Ministry of Finance

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Effect of the Reform on the Secondary Market

The entry of the pension funds into the capital market is expected to influence not only the primary market but the secondary market as well, leading to an increase in demand and a decrease in yields, in the long term, as well as a significant increase in trading volumes of tradable Government bonds. The pension funds' former investment regulations restricted their investments in the Government bonds market to 7% for the 'old' pension funds and 30% for the 'new' pension funds. Concurrently, their ability to purchase CPI-linked bonds at a guaranteed interest rate higher than market yields (in multi-annual terms) served as a negative incentive to their entry into the market. Further, the non-tradability of nontradable bonds entirely eliminated the exposure of the funds to losses due to declines in bond prices in the market, which discouraged them from entering the market even when the yields were exceptionally high and guaranteed a yield to maturity of over 6%.

Table F-2

Distribution of holdings of Government bonds by type of investor in 2003

	Bank of Israel	Foreign investors	Insurance companies	Banks	Pension funds	Provident funds	Mutual funds	Other	Total market value
	Percent								NIS billions
Total tradable Government bonds	2.4	0.4	12.8	16.5	2.0	34.5	14.1	17.3	229.6
Unlinked (Gilon and Shahr)	-	0.6	12.0	21.3	0.8	24.6	21.0	19.7	119.1
CPI-linked	5.1	0.1	14.0	11.0	3.4	45.7	4.7	16.0	107.9
Foreign currency-linked	-	0.1	12.8	2.0	1.0	10.5	38.6	35.1	5.7

Source: Bank of Israel

The announcement of the reform in pension funds in March, and its approval by the Knesset at the end of May immediately affected the secondary market, primarily the long-term bonds market. Expectations in the capital market that with the implementation of the reform and the entry of pension funds into the market, a shortage would result in the bonds market and prices would rise, led many investors to accumulate large stocks of bonds. This was one of the main causes of the sharp decline in bond yields recorded in May and June (see Diagram B-2).

Following the reform, analysts expected investments in Government bonds by pension funds to focus almost exclusively on CPI-linked tradable bonds, which, like the nontradable bonds, are linked to the Consumer Price Index and are long-term, so that they better match the liabilities of the pension funds. However, somewhat in contradiction of expectations, from the reform's implementation, in August, to November, the 'old' pension funds purchased fixed-coupon unlinked bonds ('Shahar' type) at a volume of NIS 286.5 million, and their weight in the funds' portfolio grew from zero to 0.26% during the period.⁸ Concurrently, the 'old' pension funds purchased 'Galil' type CPI-linked bonds at a volume of NIS 1.0 billion, and their weight in the asset portfolio rose from 0.5% to 1.25%. Purchases of 'Gilon' type floating-coupon unlinked bonds were negligible, as was their weight in the 'old' pension funds' portfolio. These developments may indicate that the entry of the pension funds into the capital market is expected to influence not only the CPI-linked Government bonds market, but the fixed-interest unlinked bonds market as well, and later on, the floating-interest unlinked bonds market.

Effect of the Reform on the Structure of Government Debt

The sharp reduction in the weight of nontradable bonds out of the holdings of the pension funds, and the diversion of a considerable part of their money into the capital market, will have a considerable effect on the structure of Government debt in the long term, in three main ways:

- **The increased weight of tradable debt at the expense of non-tradable debt as a share of total domestic debt** — At the end of 2002, the non-tradable domestic debt to pension funds constituted 31.2% of the total domestic debt. Directing the pension funds into the capital market and making the Government's debt to them largely tradable will lead to a considerable increase in the weight of the tradable component of the total domestic debt.
- **The increased weight of unlinked debt at the expense of linked debt as a share of total Government debt** — All nontradable bonds are linked to the Consumer Price Index. Based on the assumption that the money directed to the pension funds will be invested in CPI-linked channels as well as unlinked channels, it can be assumed that the reform in pension funds will bring about a reduction in the weight of linked debt out of total domestic debt. Note that this development is in line with the Debt Management Unit's long-term policy, as outlined in Section A.

⁸ At the end of December 2003, the holdings of pension funds in 'Shahar' bonds decreased to NIS 219.5 million, and the weight of these bonds out of total holdings of the 'old' pension funds fell to 0.21%.

- **The shortened range of domestic debt** – ‘Arad’ and ‘Miron’ bonds were issued for long terms to maturity of 15 and 20 years, respectively. The reform will lead to the cessation of issues of these bonds in the coming years. However, the Ministry of Finance does issue long-term CPI-linked bonds, and intends to continue to do so. As a result, it is not possible to know for certain whether the reform will result in a shortening or an extension of the term to maturity of Government debt; however, since not all the purchases of Government bonds by pension funds will be in linked bonds at a range longer than 15 years (and the Ministry of Finance, from its own considerations, is not expected to raise large volumes of long-term CPI-linked debt), it can be estimated that the reform in pension funds will bring about a somewhat shortened term to maturity of the domestic Government debt.

2. The Tax Reform

In June 2002, the Rabinowitz Committee submitted its recommendations for a reform in the taxation system in Israel to the Minister of Finance. The recommendations were approved by the Government and the Knesset, and took effect on January 1, 2003. The Rabinowitz Committee was preceded by the Ben-Bassat Committee, which submitted a proposal for a far-reaching reform that included taxation of the capital market, and laid the necessary legal foundations.⁹ A key component of the reform is the taxation of profits derived from the capital market, including profits derived from holdings of Government bonds (a summary of taxation rates that apply to Government bonds issued as of May, 2000 appears in Appendix E).

Taxation Rates of Government Bonds Following the Reform

Following are the taxation rates, according to the investing entity:

A. Local Individuals (Non-Business Income)

1. Unlinked bonds (‘Gilon’, ‘New Gilon’, and ‘Shahar’) – series issued prior to May 8, 2000 enjoy a full exemption from tax on interest and on capital gains. Series issued after May 8, 2000 are taxable at a nominal rate of 10% on both interest and nominal capital gains.
2. CPI-linked bonds (‘Galil’) – series issued prior to May 8, 2000 are taxable at a rate of 35% on interest, and exempt from taxation on capital gains. Series issued after May 8, 2000 are taxable at a nominal rate of 15% on both interest and real capital gains (deducting inflation).

⁹ Transitional regulations legislated immediately after the publication of the Ben-Bassat Committee’s recommendations, on May 8, 2000, enable the taxation of bonds in series issued after that date.

3. Dollar-linked bonds ('Gilboa')¹⁰ are taxable at a rate of 35% on interest, and exempt from taxation on capital gains.
4. Israeli Government bonds issued abroad – series issued prior to May 8, 2000 are taxable at a rate of 35% on interest, and exempt from taxation on capital gains. Series issued after May 8, 2000 are taxable at a rate of 15% on interest and 25% on real capital gains.¹¹ As of January 1, 2005, the taxation rate for capital gains will fall to 15%.

B. Mutual Funds

The new tax regulations define three types of mutual funds:

1. Tax-exempt funds – funds that are exempt from taxation, but in which unit owners are taxable at a rate of 25% on real capital gains when realizing units of the fund.
2. Taxable funds – funds whose profits and income on interest and capital gains are taxable, as detailed in the tax regulations for individuals.
3. Mixed funds – funds whose tax liability is divided between the fund and owners of participation units. Investors in these funds pay a 15% tax on real capital gains when realizing units of the fund.

C. Foreign investors

The regulations for taxation of bonds issued prior to May 8, 2000 apply to foreigners and to local individuals equally. With regard to bonds issued after May 8, 2000, foreign investors were exempt from taxation of capital gains derived from holdings of Government bonds; however, until September 2004, they were taxed on interest payments. The Ministry of Finance and the Tax Authority endeavored to grant all foreign investors an exemption from taxes on interest payments as well, in order to encourage their activity in the Government bonds market, which remains at a very low volume. Subsequently, in September 2004, the Knesset Economic Committee approved the regulations granting an exemption to foreign investors on interest payments received from Government bonds retroactively from January 1, 2004. Israel has thereby harmonized the taxation of foreign investors in Government bonds with the common practice in most advanced economies.

Foreign investors are exempt from payment of any tax on holdings of Israeli Government bonds issued abroad.

¹⁰ All 'Gilboa' bonds were issued prior to May 8, 2000, so that the former tax regulations apply to them.

¹¹ Relative to the currency in which the bonds are denominated.

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D. Pension Schemes

Pension funds, insurance companies (annuity policies), and compensation payments are exempt from taxes on capital gains and interest payments on holdings of government bonds.

E. Other Institutional Investors

Other institutional entities pay tax at different rates in accordance with their status as detailed in the Income Tax regulations.

Examination of the Effect of the Reform on the Government Bonds Market

The tax reform resolved a longstanding bias in tax rates of linked and unlinked bonds. Prior to the implementation of the reform, all investors, with the exception of provident funds and pension funds, were taxed at a rate of 35% on the interest paid by linked bonds, while unlinked bonds were entirely exempt from taxation. As a result, investors (non-institutional) had an incentive to invest in unlinked bonds rather than in linked bonds. In fact, in a comparison of the weight of holdings of local investors which are not provident funds, or pension funds in linked bonds, in January and December 2003, an increase can be seen, from 42.8% to 45.8%; this came, among other things, at the expense of the weight of holdings of pension funds and provident funds, which dropped from 51.0% to 49.0%. Concurrently, an increase was also recorded in the weight of the holdings of the same investors in unlinked bonds, while the weight of holdings by pension funds and provident funds decreased. Also note that these changes in the structure of holdings were influenced not only by the investment preferences of the various entities, but also by their weight in the public's financial asset portfolio. In particular, note that the weight of pension funds and provident funds out of the total financial asset portfolio of the public decreased during the period under discussion, from 36.9% to 35.3%.

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Table F-3:
Distribution of holders of CPI-linked and unlinked Government bonds by groups of investors,
2000-2003
(percent)

	Provident funds and pension funds	Others	Foreign investors	Bank of Israel
	Unlinked			
2000	31.1	68.1	0.1	-
2001	29.1	70.8	0.1	-
2002	29.4	69.4	1.3	-
2003	25.3	74.0	0.6	-
2003				
January	28.1	70.7	1.2	-
December	25.3	74.0	0.6	-
	CPI-Linked			
2000	51.4	41.3	0.2	7.1
2001	53.3	39.7	0.1	6.9
2002	50.4	43.4	0.1	6.1
2003	49.0	45.8	0.1	5.1
2003				
January	51.0	42.8	0.1	6.2
December	49.0	45.8	0.1	5.1

Source: Bank of Israel

The tax reform regulations do not apply to bonds issued prior to May 2000, which results in an inconsistency (fragmentation) in the market. In the coming years, bonds taxable at different rates as well as tax-exempt bonds will be traded simultaneously (the last tax-exempt bond will reach maturity on Oct. 30, 2014). The differential taxes are reflected in the bond prices and in gross yields, causing a distortion of the yield curves, since over the years taxed and untaxed bonds alternate. The inconsistency will continue, due also to the different taxation rates that apply to different investors..

Another bias that resulted from the gradual implementation of the reform in 2003 was the large yield gaps between 'Shahar' bonds issued prior to May 2000, which pay interest (and were therefore partially taxed in 2003), and Bank of Israel Makams, which are 'discount-papers' that pay interest in the form of capital gains (and were therefore not taxed in 2003). These disparities were particularly notable during the first months of the year, as shown in Diagram F-3. However, it should be noted that when taxation of capital gains began, on January 1, 2004, the holders of

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Makams issued during 2003 also began to pay tax. The later the Makam was issued in 2003, the period for which its holders paid tax on capital gains grew longer, and the effect of the tax reform on the yield differentials declined. In fact, as shown in Diagram F-3, as the year progressed, the yield gaps between the taxable 'Shahar' bonds and the Makam diminished.

Diagram F-4: Yields of selected 'Shahar' bonds and yields of Makams of 12 months duration



* Taxable bonds

Source: Government Debt Management Unit, Ministry of Finance

The Continued Implementation of the Tax Reform, and its Effect on the Domestic Bonds Market

At the beginning of 2005, the tax rates paid for capital gains and interest from local and foreign assets will be equalized. This is expected to lead to an increase in the share of foreign assets in the investment portfolios of local investors (institutional and private), at the expense of local assets, including Government bonds. However, it should be noted that even sophisticated markets open to capital movements are characterized by a preference for local assets (a 'home bias'). The key reason for this bias is investors' greater familiarity with the characteristics of the domestic market, and the economic and political environment in which it operates, as well as with the structure and activities of local companies. This information significantly reduces the risk perceived in a local investment; thus, there is no expectation of a quick massive migration of investors from the Government bonds market to international markets.



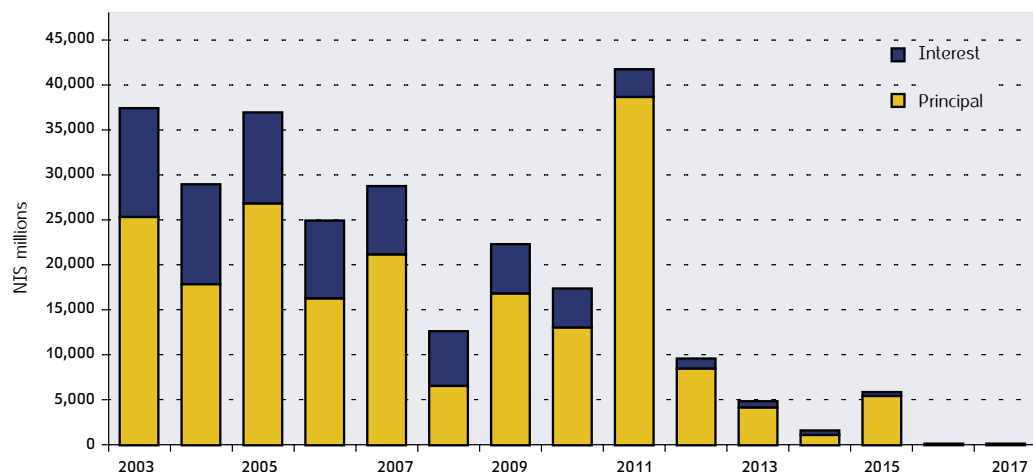
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At the same time, the Government Debt Management Unit is working to expand the circle of investors and the activity of foreign investors in the bonds market. A key means to this end is the introduction of international financial entities as primary dealers on the domestic bonds market. These entities will be able to increase the volume of foreign investments in Government bonds, due to their global distribution systems, thereby compensating for the exit of some of the funds of local investors from the domestic market to global markets.

Appendices

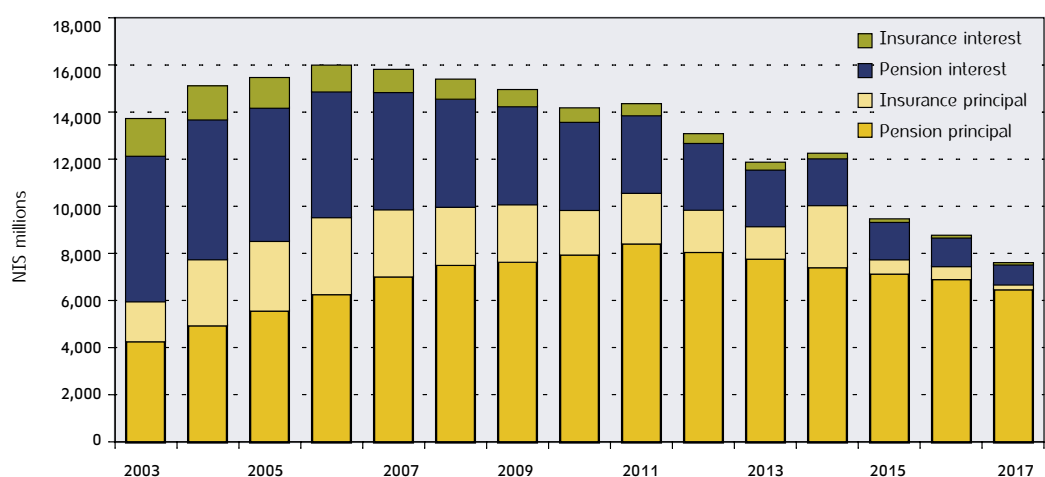
Appendix A: Structure of Maturities – Dec. 31, 2003

Diagram AP-1: Maturities of principal and interest payments on tradable domestic debt



Source: Bank of Israel

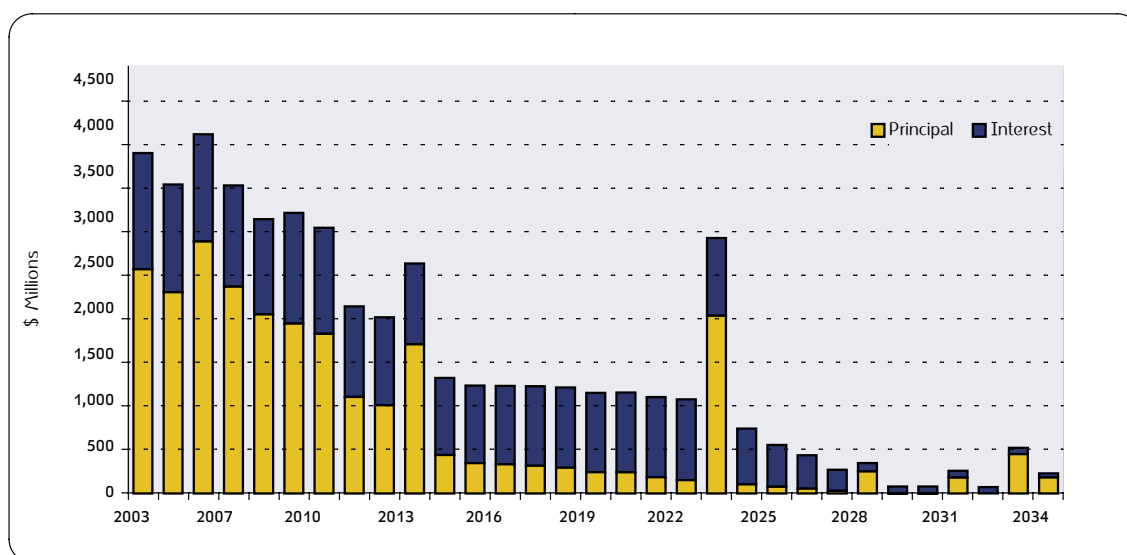
Diagram AP-2: Maturities of principal and interest payments on non-tradable domestic debt



Source: Bank of Israel

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Diagram AP-3: Maturities of principal and interest payments on external debt



Source: Debt Management Unit

Appendix B: Distribution of Tradable Funding by Linkage Type in 2003

	Unlinked, fixed- interest ('Shahar')	Unlinked, floating- interest ('New Gilon')	CPI-linked, fixed- interest ('Galil')	Total in NIS millions
	Percentages			
January	34.0	36.0	30.0	5,150
February	31.0	34.0	35.0	4,217
March	40.0	34.0	26.0	4,036
April	45.0	35.0	20.0	3,851
May	32.0	28.0	40.0	2,358
June	37.0	20.0	43.0	2,805
July	37.0	18.0	45.0	2,909
August	42.0	24.0	34.0	3,379
September	55.0	15.0	30.0	2,813
October	34.3	14.3	51.4	3,335
November	30.0	16.7	53.3	4,280
December	31.7	16.7	51.6	5,750
Total	37.3	23.9	38.8	44,883

Source: Government Debt Management Unit

Appendix C: Characteristics of Tradable Bonds in the Domestic Market

Bond	First issue date	Interest	Interest payment	Term to maturity
CPI-linked				
New Kfir*	Feb. 15, 1998	Floating – based on yields of fixed-interest CPI-linked bonds - 2-5 years to maturity.	Once every three months.	Issued for periods of 6 years. Possible range to maturity: 1-25 years. Note: only one series was issued, and redeemed on Jan. 31, 2004.
Galil	Dec. 31, 1984	Fixed – based on average yields of fixed-interest rate CPI-linked bonds, according to the term to maturity of the series, or 1% (whichever is higher).	Once annually.	Series are currently issued for 10 and 20 years.
Dollar-linked				
Gilboa*	Oct. 24, 1988	Floating – based on six-month LIBOR interest rate.	Once every six months.	Issued for periods of 4-5 and 10 years. Possible range to maturity: 2-25 years.
Unlinked				
Gilon*	Jul. 2, 1992	Floating – based on Makam yields for a period of 3-12 months.	Once every six months.	Issued for periods of 2-7 years. Possible range to maturity: 1-10 years. At the end of 2003, only one series remained in circulation.
New Gilon	Apr. 28, 1999	Floating – based on Makam yields for a period of 3-12 months.	Once every three months.	Issued for periods of 4, 5, and 10 years. Possible range to maturity: 1-25 years.
Shahar	Aug. 24, 1995	Fixed – as determined by the Ministry of Finance.	Once annually.	Issued for periods of 5 and 10 years. Possible range to maturity: 1-30 years.

Appendix D: Characteristics of Bonds Issued by the Bonds Organization

Bond type	Interest equation	Interest payment	Repayment period (years)	Minimum purchase	Additional parameters
Fixed interest					
5-year Jubilee	TB5y + spread	Twice annually	5	\$25,000 (and in multiples of \$5,000)	
10-year Jubilee	TB10y + spread	Twice annually	10	\$25,000 (and in multiples of \$5,000)	
Development	4%	Once annually	15	\$500 (and in multiples of \$500)	May be redeemed early in Israel, up to a total of \$2,500 monthly.
ZERO: Development saving	4%	End of period	15	\$500 (and in multiples of \$500)	
ZERO: Development int'l	4%	End of period	15	\$500 (and in multiples of \$500)	The bond is intended for investors outside the USA.
Chai	4.5%	End of period	5	\$144 (and in multiples of \$180)	Non-tradable, no early redemption.
Zero Coupon	Strip10y + spread	End of period	10	\$3,382	No early redemption.
Canadian Zero Coupon	Strip10y + spread	End of period	10	\$3,305 Canadian	No early redemption.
Canadian Zero Coupon	Strip 5y + spread	End of period	5	\$136 Canadian (and in multiples of \$180)	No early redemption.
Canadian EDI	Canadian TB5y + spread	Twice annually	5	\$25,000 Canadian (and in multiples of \$5,000)	No early redemption.
Floating interest					
Bond Floating	Libor + 75	Twice annually	10	\$5,000 (and in multiples of \$2,500)	Not approved for sale to banks; possibility of liens; may be redeemed early.
3rd Variable Rate Libor Notes	Libor + 60bp	Twice annually	5	\$100,000 (and in multiples of \$25,000)	Not approved for sale to banks.
Libor Notes	Libor + 40bp	Twice annually	7	\$150,000 (and in multiples of \$50,000)	May be redeemed early.
Canadian FRI	Canadian prime - 0.75%	Twice annually	12	\$5,000 Canadian	

Appendix E: Tax Rates Applicable to Government Bonds Issued After May 8, 2000

		Residents	Non-residents	Mutual funds			Institutional
				Exempt	Taxable	Mixed	
Local							
Unlinked bonds	Capital gains	10% beginning Jan. 1, 2004	0%	0%	10% beginning Jan. 1, 2004	Investors in these funds will pay tax on real capital gains at a rate of 15% upon realization of the fund.	0%
	Interest	10%	10%***	0%	10%		0%
CPI-linked bonds	Real capital gains	15% beginning Jan. 1, 2004	0%	0%	15% beginning Jan. 1, 2004		0%
	Interest	15%	15%***	0%	15%		0%
USD-linked bonds*	Real capital gains	15% beginning Jan. 1, 2004	0%	0%	15% beginning Jan. 1, 2004		0%
	Interest	15%	15%***	0%	15%		0%
Abroad							
Israeli Government bonds issued abroad	Capital gains	25% beginning Jan. 1, 2004**	0%	0%	25% beginning Jan. 1, 2004**	Investors in these funds will pay tax on real* capital gains at a rate of 15% upon realization of the fund.	0%
	Interest	15%	0%	0%	15%		0%

* Relative to the currency in which the bond is denominated.

** 15% as of January 1, 2005.

*** 0% as of January 1, 2004, subsequent to the amendment initiated by the Debt Management Unit together with the Tax Authority.

Appendix F: Government Debt Management Unit – Personnel

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