The importance of a well developed bond market - an Israeli perspective

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1. Introduction

Well developed tradable debt securities are important for three main reasons:

- increasing the competitiveness and efficiency of the financial system, which in Israel is dominated by a few large banks;
- enhancing the stability of the financial system by creating alternatives to banks, thus reducing their relative power and the related moral hazard problems; and
- serving as a means of two-way communication between policy-makers and financial markets, and through them with the public at large.

This paper discusses these three roles as they relate to the current functioning of the Israeli financial system.

2. Competitiveness and efficiency

Financial intermediation in Israel is at present dominated by a large few banks. This is evident, for example, in the high proportion of bank loans in total financial resources available to businesses and households (Table 1).

Table 1

Financing of the private sector

(% shares)

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001e**
Credit from banks in Israel	71	74	90	96	87	78	82	72	69	86
Capital raised abroad	6	3	0	1	10	10	6	19	13	9
Capital raised in Israel	23	23	10	3	3	12	12	9	18	5
Total (billions of shekels)	22	41	56	78	60	64	80	73	75	

Private sector fund-raising outside the banking system through the issuing of shares is rather limited and the corporate bond market is minuscule. The main competition to banks for the public's savings comes from government bonds. Despite the large outstanding government debt (about 95% of GDP in 2001), the government bond market suffers, for various reasons, from liquidity problems. In contrast to the interest of foreign investors in Israeli shares, particularly those that are traded on the Nasdaq, there is almost no interest in domestically issued Israeli bonds.

Developing viable alternatives to bank finance in Israel will help in promoting balanced growth. The Israeli economy has been undergoing structural change, notably an increase in the weight of the advanced high-tech sector, with its relatively easy access to sources of finance such as venture capital and international capital markets. This underscores the need to develop sources of non-bank finance for the other sectors of the economy so that they too can grow.

3. Enhancing the stability of the financial system

Developing a viable bond market in Israel will also enhance the stability of the financial system. When firms can raise funds by issuing bonds, they are less dependent on banks, less exposed to difficulties in the banking system and less vulnerable to the adjustments that banks need to make, including those required by bank supervisors. When banks know that they do not have a captive audience because firms have alternatives, they may improve their internal supervision. Having alternatives to banks may therefore result in a more sound banking and financial system.

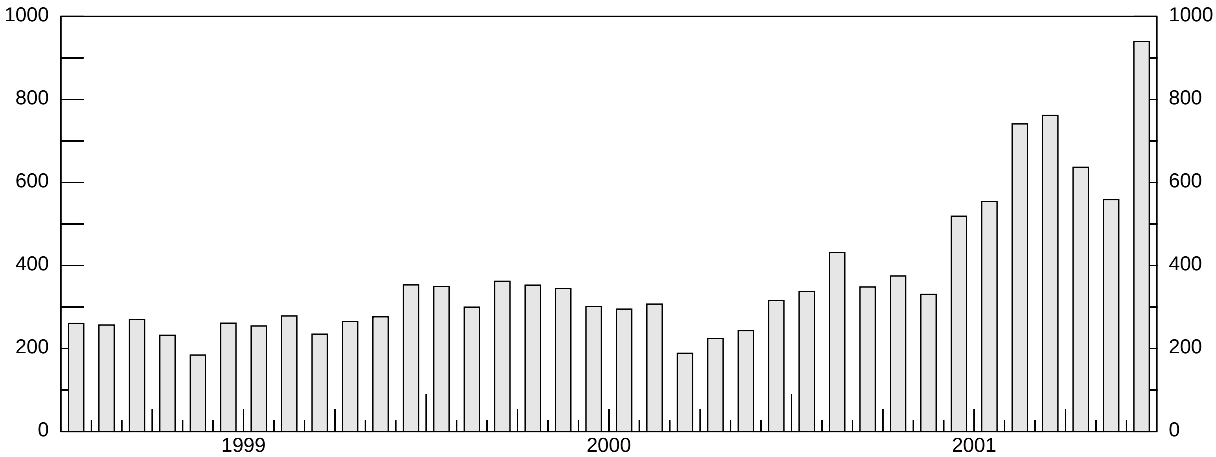
Another way in which a well developed bond market contributes to the stability of the financial system is through its positive effects on the development of securitisation. A more efficient diversification of risks can result from securitising mortgages and other receivables such as credit card payments. This in turn enhances the stability of the banking and the financial system as risk becomes more transferable to those ready to bear it.

In addition, in mature capital markets with a range of bonds of various types, it is easier to mark to market. This in turn means that trouble spots in the financial system can be detected earlier. At present Israel is still very underdeveloped in the above respects. There is no market for mortgage-backed securities nor any securitisation of other types of loans. Mortgage banks sometimes sell some mortgages to provident funds but on a limited and infrequent basis.

An important infrastructure for the private bond market is a well functioning government bond market. The outstanding stock of government bonds in Israel is 178 billion shekels, about 38% of GDP. Net issuance of government bonds in 2001 amounted to 16 billion shekels. The rest are non-tradable bonds issued to pension funds, thus creating a situation where a potentially important player is effectively circumventing the capital market.

Graph 1
Government bonds: average daily turnover1

In millions of shekels



[1] On and off the Stock Exchange.

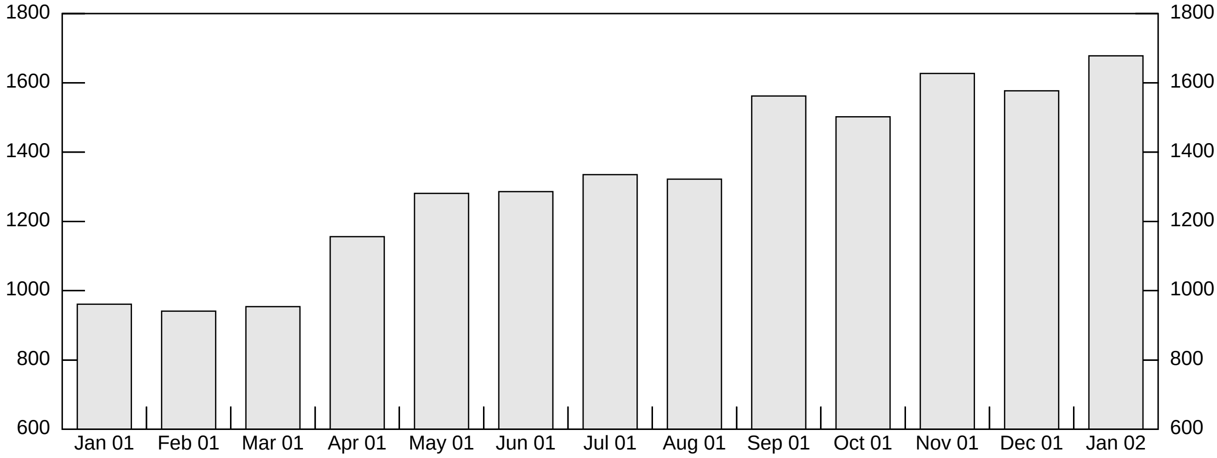
Despite this deficiency, and others, the liquidity of the government bond market has been improving in recent years. Daily turnover of government bonds traded on the Tel Aviv stock exchange increased markedly in 2001 (Graph 1) and so have short positions (Graph 2).

Reducing the number of series and concentrating on benchmark maturities of five and 10 years for the fixed rate nominal bonds, 10 years for variable rate nominal bonds and 10 and 20 years for the CPI-linked bonds improved the functioning of Israeli bond markets. Furthermore, the size and composition of the government bond auctions are now announced a month in advance.

Graph 2

Short selling of government bonds

End-month balance, in millions of shekels



A cornerstone of a mature capital market is the ability to conduct repo operations (secured lending). There are currently no central bank repo operations in Israel, but a legal obstacle has recently been removed. The ceiling limiting the issue of short-term government notes (which are legally designed only for monetary policy purposes and whose proceeds cannot be used to finance the government deficit) to an amount updated twice a year by the rate of increase in M1 during the previous half year was removed. This is a welcome development as central bank repo operations serve as an important benchmark for such operations in the private sector, which in turn provide an alternative finance source to banks.

4. Signal to policymakers

There have been two recent examples where bond markets have served as important "warning lights" concerning problematic macro policies. In 1996 the government deficit in Israel grew much faster than originally planned at a time when inflation expectations were above the inflation target. The government decided to cut expenditures and, based on this decision, asked the Bank of Israel to ease its monetary stance. The central bank's response was that the decision to take the corrective fiscal measures was certainly an important step in the right direction, but it was also important to see how credible this decision was from the point of view of financial markets. In particular, it was important to see how the market's inflation expectations responded to the government decisions. These expectations are derived from the difference between yields on regular nominal bonds and CPI-indexed bonds with the same maturity. Both types of bonds are traded regularly in a relatively well developed market. These inflation expectations are an important element in the monthly monetary policy decisions of the Bank of Israel.

The slump in economic activity in 2001 resulted in much smaller tax receipts than expected, a much larger deficit than planned and hence much larger government financing needs. The government originally planned to raise (net) about 3 billion shekels in 2001 but ended up raising more than 16 billion. This obviously affected the long-term rate, which also serves as a benchmark for the mortgage market. Those yields rose from around 4.3% to around 4.9% in the third quarter of 2001. The existence of developed government bond and mortgage markets was very important in making the point that the government decision to accept the larger deficit (the automatic stabiliser argument) had immediate consequences in the mortgage market. In an important sense the "bill" to the government was "presented" immediately.