Chapter 4
The Financial Markets and Sources of Financing for Economic Activity

- Financial market prices increased both in Israel and worldwide in 2013, against the background of accommodative monetary policy in advanced economies, while real economic activity continued to be moderate.
- The value of the public's financial asset portfolio continued to increase. The proportion of Israeli and foreign equities increased while the share of bank deposits decreased. In addition, the proportion of assets managed by institutional investors increased following the reforms in the pension savings market in recent years.
- Credit in the economy (not including credit to the financial sector) grew by about 3 percent in 2013, as a result of an increase in credit to households, primarily for housing, which was partly offset by a decrease in credit to the business sector.
- The decrease in credit to the business sector was accompanied by a decline in spreads and yields in the corporate bond market and by lower interest rates on bank credit to the business sector. This combination is characteristic of decreased demand for credit by businesses, and is consistent with a contraction in the funding constraint faced by companies, as reflected in various surveys and in growth in unutilized credit lines.
- Risk management, regulation, and capital adequacy considerations all affected the allocation of bank credit, and led to a contraction of credit to large borrowers and to business groups as well as to expansion of credit to households and small businesses.
- Differences in regulation between tradable debt and nontradable debt led institutional investors to continue to increase direct loans to companies in 2013 as well. This was in parallel with a slow increase in primary market debt and equity issuances.
- In 2013, the deficit in the financial account of the Balance of Payments continued, balancing the surplus in the current account.
- The increase in Israeli residents' net investment abroad continued, made up primarily of financial investments in tradable securities. In particular, Israeli institutional investors continued to increase their exposure to foreign assets, though more than fully hedging the increase in their foreign currency exposure.
- Nonresidents' direct investment in Israel reached a high level of $11.8 billion, and their level as a share of GDP is high in international comparison. On the other hand, nonresidents' holdings of short term financial investment instruments continued to contract, and as a result their effect on short term forces affecting the exchange rate declined.

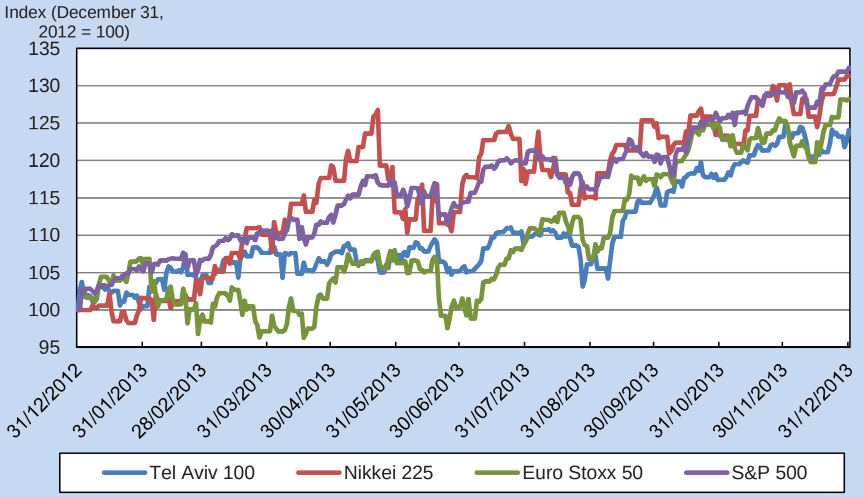
1. DEVELOPMENTS IN THE FINANCIAL MARKETS

Stock prices in Israel increased in 2013, similar to stock prices in most of the advanced markets.

In 2013, prices increased in financial markets both in Israel and abroad. During the year, real economic activity remained moderate, though the pace of recovery from the crisis varied widely among countries (see Chapter 1). While real activity was moderate, financial markets of advanced economies, including Israel, rose sharply during the year, against the background of the accommodative monetary policy adopted in the advanced economies (see Chapter 3).

Trends in the advanced economies' stock markets were not uniform over the course of the year, and they were influenced to a significant degree by several factors: assessments of when the tapering of quantitative easing in the US would begin (see Chapter 7C for a discussion of the tapering and its repercussions); assessments of future developments in the eurozone; and actual and projected growth data for various countries. From the beginning of the year until May, stock markets rose, against the background of declarations by European policymakers of their commitment to preserve the integrity of the eurozone and as a result of the highly accommodative monetary policy in Japan. At the end of May, then-Chairman of the Federal Reserve Ben Bernanke announced that the Federal Reserve (the Fed) might begin tapering its asset purchases, and markets fell in reaction. In September and October, the Fed announced that it would continue purchasing bonds during those months and in November positive growth figures for the third quarter were reported for Europe. All these provided support for the sharp price increases during the last third of 2013 (Figure 4.1). In contrast to advanced economies, the developing economies showed negative returns in 2013, against the background of the slowdown in growth many

Figure 4.1
Share Price Indices in Israel and Abroad, in Dollar Terms[a], 2013



[a] Total yield indices.
SOURCE: Bloomberg.

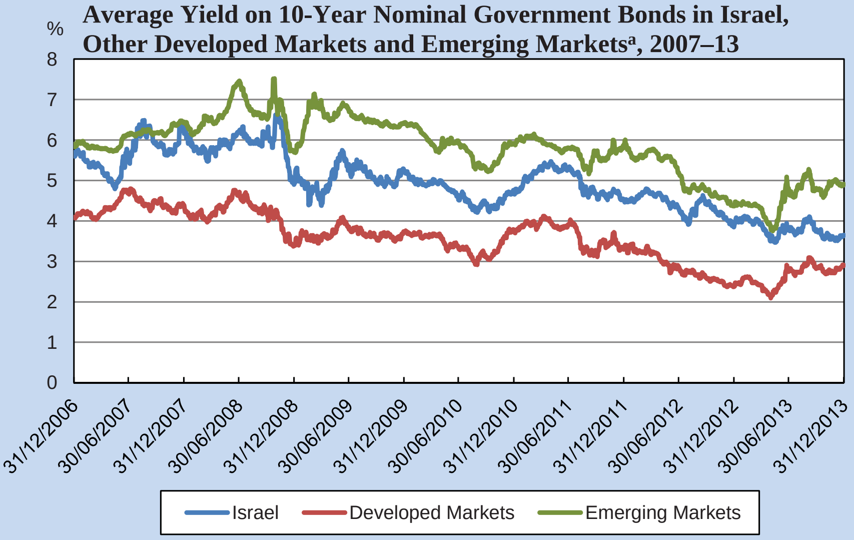
of them experienced and the flight of capital as a result of the expectations for the tapering of the quantitative easing in the US.

The stock market in Israel responded with a lag to the price increases in the stock markets of most advanced economies, and the trend in share prices in Israel resembled that in Europe. Only at the start of September, following the easing of tension on the Syrian front, did prices begin to rise sharply. These price increases received support in September and October from forecasts that the tapering of quantitative easing in the US would be postponed.

The yield spread between Israel and the other advanced economies narrowed against the background of the decline in monetary interest rates and in Israel's sovereign risk premium.

Yields on long-term government bonds in Israel continued to decline in 2013 and yields on 10-year nominal government bonds declined by about 20 basis points for the year. Long-term yields in advanced and developing economies, in contrast, started to rise in 2013, based on the expectations for the tapering of quantitative easing. This followed two years of declining yields (Figure 4.2). As a result the yield spread between Israel and the advanced economies narrowed.

Figure 4.2
Average Yield on 10-Year Nominal Government Bonds in Israel, Other Developed Markets and Emerging Markets[a], 2007–13



[a] Classification of developed markets and emerging markets is according to MSCI indices. Data relate to all countries for which we had data throughout the period, excluding Greece, since its MSCI index classification changed in 2013 from developed market to emerging market.
SOURCE: Based on Bloomberg.

The narrowing of the yield spread was affected by the reduction in the monetary interest rate and the decline in Israel's risk premium: Israel's CDS spread, which reflects its risk of default, declined by 36 basis points in 2013 to its lowest level since 2009, continuing the trend that began in 2012. This should be viewed against the background of the recovery in the advanced economies and the decline in their default risk, which contrasts with the increase in default risk in developing economies. The decline in Israel's CDS spread in 2013 was also supported by: a) reduced fiscal risk following the approval of the 2013–14 budget, which boosted investors' confidence in the government's commitment to fiscal discipline (see Chapter 6); and b) reduced geopolitical risk, particularly that originating in Syria. Against the background of declining yields on government bonds and in parallel with the prices increases on the stock market, the corporate bond market in Israel also rose and yields reached a record low.

2. NATIONAL SAVING AND THE PUBLIC'S FINANCIAL ASSET PORTFOLIO

The economy's total gross national saving was about NIS 209 billion in 2013. This amount, alongside net capital inflow that is not channeled to consumption, constitutes the basis for investment in the Israeli economy. The public's portfolio of financial assets (Table 4.1) includes the public's financial investments and the holdings of controlling shareholders in publicly traded companies.

The value of the public's financial asset portfolio continued to increase in 2013, with an increase in the proportion of Israeli and foreign stocks and a decline in the proportion of bank deposits.

In recent years, the size of the public's asset portfolio has been stable relative to GDP, in contrast to the period prior to 2007 when it grew rapidly. The following trends characterized the composition of the asset portfolio during the last decade: a) a decline in the proportion of cash and deposits and *makam*, which was supported by the rapid decline in real yields and interest rates in Israel and advanced economies; b) an increase in the proportion of tradable corporate bonds, which was supported by the reforms carried out in the economy's saving channels; and c) an increase in the proportion of foreign shares, which was supported by the tax reform that for the first time imposed a tax on financial investments in Israel and equalized tax rates on securities in Israel to those on foreign securities.

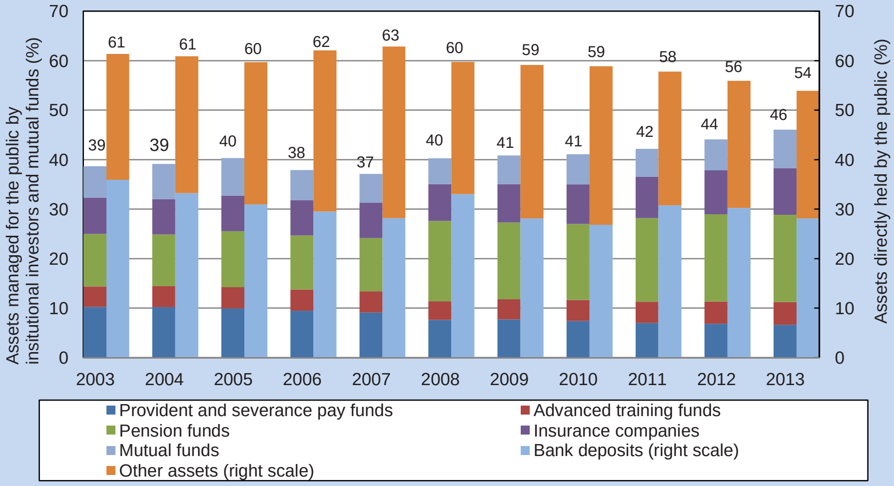
The value of the public's financial asset portfolio continued to increase in 2013, against the background of price increases in the various financial markets. The balances of equities in Israel and abroad each grew by more than 20 percent in 2013. According to the Bank of Israel's estimates, the increase in the value of Israeli shares is almost entirely due to the increase in their prices, while this accounts for less than half of the increase in foreign shares, with the rest due to purchases. It should be noted that according to the estimates of the Bank of Israel, the purchase of shares abroad has increased by more than 10 percent in each of the previous three years, and the proportion of foreign shares in the asset portfolio has grown faster than the proportion of any other asset class.

The proportion of assets held through institutional investors continued to grow, in view of the reforms implemented in the long-term savings market in recent years.

Simultaneous with the changes in the composition of the asset portfolio, there have also been changes in the composition of asset holders (Figure 4.3). During the past decade, the share of financial assets held directly by the public has declined, which is particularly the case for bank deposits. In contrast, the proportion held indirectly through institutional investors[1] and mutual funds has grown. As a result, the sources

[1] Pension funds, insurance companies, provident funds and advanced training funds.

Figure 4.3
Distribution of the Public's Financial Asset Portfolio, by Institutional Composition, 2003–13



SOURCE: Bank of Israel.

available to institutional investors have increased during this period at a faster rate than the sources available to the banks.

The increase in the share of institutional investors derives primarily from growth in long-term savings, and first and foremost saving in the new pension funds. This can be attributed to reforms in the long-term savings market. In contrast, the share of the provident funds in the public's asset holdings has declined, against the background of legislative changes that reduced their attractiveness.[2]

The mutual funds industry grew rapidly in 2013, mainly in money market funds, funds which specialize in other bonds, and funds that specialize in equities in Israel and abroad.

The mutual fund industry grew rapidly in 2013. Total assets held in mutual funds grew by 35 percent, to NIS 230 billion. If the price effect is neutralized (yielding net investments), then mutual fund assets grew by about 31 percent, the highest rate of growth since 2003. The majority of net investments was in money market funds, funds which specialize in other bonds[3], and funds that specialize in equities in Israel and abroad. Since total net issues of shares and corporate bonds were relatively low, the increase in demand for stocks and bonds through mutual funds helped drive the increase in stock market indices and the narrowing of corporate bond spreads during the past year.

[2] For further details on the changes in the long-term savings market and the provident fund market, see Achdut, L. and A. Spivak, "The Pension System in Israel after 15 Years of Reforms", Policy Studies 8, Van Leer Institute, 2010 (in Hebrew).

[3] Although funds that specialize in other bonds invest primarily in corporate bonds, they nonetheless invest a significant portion of their assets in government bonds. These funds increased their holdings of government bonds this year, and therefore, even though the total assets of funds specializing in government bonds decreased this year, total holdings of government bonds in the asset portfolio of the mutual funds grew by about 30 percent in 2013.

Table 4.1
Distribution of the public's financial asset portfolio[a], by type of asset, 2003–13

Period	Total portfolio	Portfolio as a share of GDP	Cash and deposits	Government bonds		Corporate bonds[b]		*Makam*	Stocks[d] in Israel	Israeli residents' investments abroad[e]			
				Tradable	Nontradable[f]	Tradable	Nontradable[c]			Deposits	Bonds	Stocks	Other
	NIS billion	Distribution in percent											
2003	1,313.1	233.1	40.6	14.3	11.4	1.9	2.3	3.6	15.1	3.7	3.2	2.0	1.9
2004	1,420.9	240.1	37.9	14.2	10.2	2.4	2.7	4.5	16.8	3.7	3.6	2.7	1.4
2005	1,648.1	263.0	34.6	12.7	8.7	4.0	3.6	4.1	18.8	3.9	4.3	3.4	1.9
2006	1,831.7	272.3	32.5	11.0	7.5	5.0	3.9	4.6	21.5	3.9	4.1	3.8	2.2
2007	2,046.9	284.8	30.9	10.2	6.6	7.4	3.9	3.3	23.9	4.1	3.6	3.8	2.4
2008	1,877.8	245.6	37.2	13.9	11.2	6.9	2.9	3.5	11.7	3.9	3.1	3.0	2.7
2009	2,299.9	284.2	31.7	12.6	9.4	8.7	2.6	2.7	18.8	3.2	3.1	4.6	2.5
2010	2,556.1	295.1	30.1	12.0	8.7	9.3	2.2	2.7	21.4	2.3	3.2	5.5	2.5
2011	2,526.1	273.4	34.0	12.1	9.6	9.4	2.2	3.0	15.5	1.8	3.8	5.9	2.7
2012	2,722.6	274.1	33.6	13.1	9.4	9.4	1.9	2.6	15.0	1.1	3.9	6.7	3.1
2013	2,961.4	281.3	32.0	13.0	9.4	9.0	1.6	2.6	16.8	0.8	3.8	7.7	3.1

[a] The public does not include the government, the Bank of Israel, investments by nonresidents, the commercial banks and mortgage banks.
[b] Including convertible bonds.
[c] Holdings by institutional investors only.
[d] Including warrants.
[e] Including investments in Israeli securities traded abroad, and excluding investment in TASE-traded ETFs tracking foreign indices.
[f] Since February 2008, the figure includes the government's commitment to assist the old pension funds. This commitment was NIS 72 billion in February 2008.
SOURCE: Bank of Israel.

The significant increase in mutual fund assets in 2013 can be divided into two phenomena: a) A shift from bank deposits, which bear significantly lower rates of interest than the Bank of Israel interest rate and have low liquidity, to money market funds, which are characterized by a return much closer to the Bank of Israel interest rate, high liquidity and the low level of risk characteristic of bank deposits. This shift occurred against the background of a reduction in the Bank of Israel interest rate to a very low level. Total bank deposits remained unchanged during the past year while the long-term rate of increase stands at about 6 percent—which is equivalent to about NIS 50 billion. The total value of money market funds, in contrast, grew by about NIS 26 billion. b) A shift to funds specializing in stocks and bonds. A reason for this shift was the low level of bank interest rates and government bond yields, which encouraged the public to look for investments with a higher risk /return profile.

The holdings of ETFs also increased sharply in 2013. Total holdings (excluding deposit certificate ETFs[4], which almost doubled to about 20 percent of the market) grew by about 50 percent to about NIS 89 billion. The increase was concentrated in the ETFs of stocks and bonds in Israel and of advanced economies in America and Europe and its total value is very significant even after neutralizing the effect of increases in financial asset prices. The public's total holdings of ETFs on stocks in Israel was about NIS 32 billion at the end of 2013, about 5 percent of total stock market capitalization (and about 8 percent of the float) in contrast to about 3 percent (and 5.5 percent of the float) in 2011, against the background of the relatively low volume of equity issues.

The holdings of ETFs also increased sharply in 2013. The public's total holdings of ETFs of stocks in Israel increased to about 5 percent of total stock market capitalization.

3. FINANCING OF ECONOMIC ACTIVITY

The financing of economic activity is derived from the demand for sources by the government, households and the business sector, and, against it, the internal sources of these sectors and the supply of savings directed to providing credit and to investing in equities (Table 4.2). The government requires sources in order to finance the budget deficit and is a net borrower. Households are net lenders; however, some of them—particularly young households—need credit, primarily to shift income from the future to the present.[5] The business sector is a net borrower and uses credit in order to finance current activity and its investment needs. The government's financing needs and its sources for raising debt are described in Chapter 6. Below, we will describe the financing needs and sources of raising debt of households and the business sector.

[4] These are ETFs that invest in short-term bank deposits, which benefit from an interest rate very near to that of the central bank due to the large size of the deposits.

[5] According to the life-cycle hypothesis (Modigliani, 1949), individuals try to smooth consumption over their lifetime. The use of credit makes it possible to transfer income from one period to another and thus to smooth consumption. For example, mortgages are a significant portion of household credit and when households purchase an apartment using a mortgage they are transferring future income to the present in order to consume housing services.

Table 4.2

Distribution of debt balances in the economy among lending and borrowing sectors, (excluding the financial sector), December 2013, NIS billion

Lending sectors	Borrowing sectors: Households	Business sector	Government	Total debt in the economy
Total debt to banks	**369**	**388**	**79**	**837**
Nonhousing credit to the public	105	386	15	506
Housing credit to the public	265			265
Tradable bonds		2	64	66
Total debt to institutional investors	**7**	**150**	**381**	**538**
Loans	7	44	7	58
Tradable bonds		74	218	292
Nontradable bonds		32	156	188
Total debt to credit card companies	**10**	**1**		**12**
Loans	10	1		12
Total debt to nonresidents	**0**	**145**	**98**	**243**
Loans	0	126	4	130
Tradable bonds		19	72	91
Nontradable bonds		0	22	22
Debt from government sources	**23**	**4**		**27**
Targeted credit	23	4		27
Debt to households and others		**90**	**154**	**244**
Tradable bonds		90	154	244
Total debt	**410**	**779**	**711**	**1900**

SOURCE: Bank of Israel.

a. Households

Households' need for financing is a result of the gap between their income and their total consumption, and they are net savers. However, as noted, a portion of households use credit, in certain periods, in order to consume amounts that exceed their current income. This can be seen in the public's asset portfolio: the majority of the portfolio belongs to households and its value is significantly higher than total credit to households which stood at NIS 410 billion at the end of 2013 and housing credit amounted to about 70 percent of that amount.

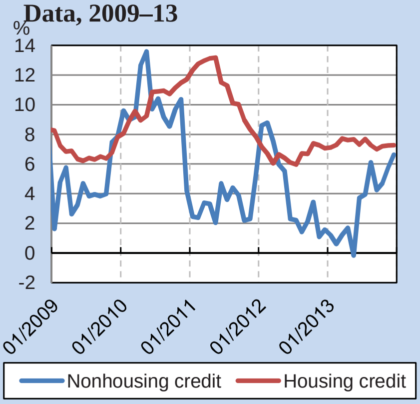
In 2013, the increase in housing credit continued, and the pace of growth stabilized at a high level. The pace of growth of non-housing credit to households began increasing in the middle of the year.

Housing credit has accounted for most of the increase in credit to households in recent years. Although its annual rate of increase has moderated since mid-2011, following policy measures adopted by the Bank of Israel and the government,[6] its level is still high (Figure 4.4) and total new mortgage volume reached a record level

[6] For further details on the measures adopted, see the 2011 Bank of Israel Annual Report, Chapter 4.

in 2013 (see Chapter 7A). The weighted real rate of interest on new mortgages has declined since the end of 2011; however, in mid-2013 its downtrend leveled off, and in the second half of the year the rate even rose somewhat, even though the monetary interest rate and long-term yields continued to decline during 2013. The change in the trend of the real interest rate on mortgages, which was accompanied, as mentioned, by the stabilization of the rate of growth in mortgage credit, occurred against the background of the limitations imposed by the Supervisor of Banks on the mortgage market during the past year[7], and against the background of the somewhat more moderate rate of increase in home prices during the second half of the year. The annual rate of increase in non-housing credit has moderated since 2012, and in mid-2013 it even neared zero. However, since then there has been an uptrend and this parallels the stabilization in the rate of growth in housing credit (Figure 4.4).

Figure 4.4
Housing and Nonhousing Credit to Households[a], Rate of Change in the Past 12 Months, Monthly Data, 2009–13



[a] Housing credit constituted about 70 percent of total credit to households at the end of 2013.
SOURCE: Bank of Israel.

The changes in housing and nonhousing credit balances are primarily the result of changes in bank credit to households. The Banking Supervision Department regulations specify that in the calculation of risk assets, housing credit for the most part receives a lower weight than business credit or nonhousing credit to households[8], and the growth in this part of bank credit, which was based on strong demand from households, helped the banks to meet the requirements of directives regarding capital ratios. Thus, from 2008 until the third quarter of 2013, the banks increased their total gross exposure (before credit losses) to households by about NIS 120 billion and reduced their gross exposure (before credit losses) to the business sector by about NIS 53 billion. These changes were reflected in an increase of only about NIS 17 billion in banks' risk assets.[9] The growth in household credit, and in particular housing credit, at the expense of business sector credit, increases the exposure of the banks to home prices; yet at the same time it improves the diversification of their credit portfolio.

In recent years, there has been a rapid growth in the proportion of housing credit in total bank credit, which is consistent with the banks meeting the requirements of the Supervisor of Banks' directives regarding capital ratios.

Housing credit is used not only to finance housing services, but also for investment purposes. The low yields and interest rates in the economy, along with the fact that the

[7] Further details of the changes made by the Supervisor of Banks in 2013 appear in Chapter 7A.
[8] This is in light of its contribution to the diversification of the credit portfolio and as a result of it being secured by a residential asset.
[9] An increase of NIS 120 billion in the exposure to households resulted in an increase of NIS 53 billion in risk assets while a decrease of NIS 53 billion in the exposure to the business sector resulted in a sharper proportional decline—of NIS 36 billion—in risk assets. This is due to the fact that in the calculation of risk assets, credit to the business sector receives a larger weight.

About half of the savers who have chosen to purchase a dwelling as an investment asset used credit for the purchase.

tax imposed on financial assets is higher than the effective tax on direct investment in housing, have increased the attractiveness of purchasing a dwelling for investment purposes.[10] The share of households who own two or more dwellings increased from 3.3 percent in 2008 to 7.9 percent in 2012. However, this investment channel is not efficient and a more expensive dwelling cannot be divided into smaller investment units. As a result, some of the savers who have chosen to purchase a dwelling as an investment asset are in need of credit and they constitute about one-half of those investing in housing.[11] About 15 percent of total mortgages granted in 2013 were intended for the purpose of investment, which is somewhat more than in 2012.

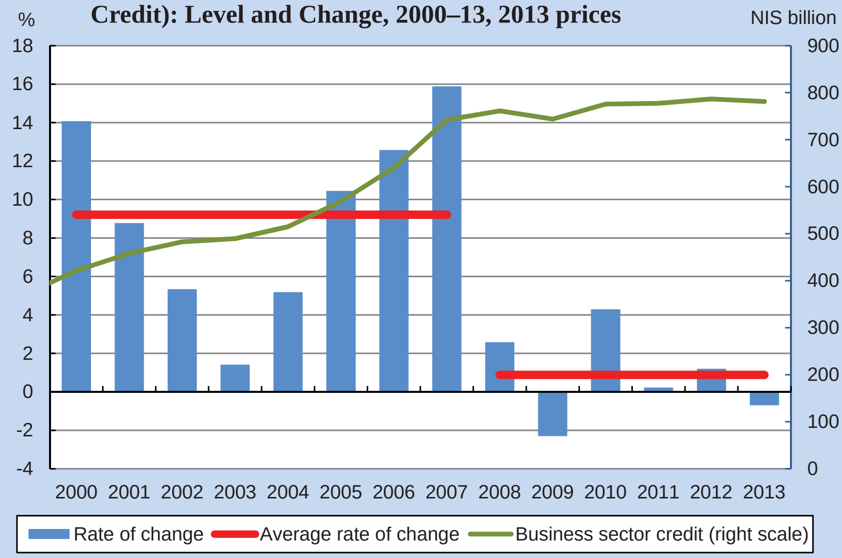
b. The business sector

In 2013, nonresidential fixed capital formation totaled about NIS 137 billion, which is similar to its level of about NIS 134 billion in 2012[12] (for further details on investment in the economy, see Chapter 2). These investments are financed from internal sources (retained earnings), credit and equity.

In recent years, there has been a slow increase in credit to the business sector, with a sharp decline in the ratio between credit to the business sector and business sector product.

Since the global financial crisis, there has been a slow increase in credit to the business sector in constant prices (Figure 4.5) and as a result the ratio between credit

Figure 4.5
Balance of Business Sector Debt (Total Bank and Nonbank Credit): Level and Change, 2000–13, 2013 prices



SOURCE: Bank of Israel.

[10] It is not only investors who purchase housing as an asset; the purchase of a home for residence also has an asset component and is influenced by the same factors that affect investors.

[11] For further details on the characteristics of investors in housing, see Box 2.3 in the Bank of Israel Annual Report for 2011.

[12] In 2010 prices, according to National Account data. In addition to investment, the business sector needs to finance current activity and this financing need is not reflected in the investment figures of the National Accounts.

to the business sector and business sector product has declined from a level of about 120 percent in 2009–10 to about 100 percent in 2013, which is low relative to other advanced economies. At the same time, there has been a slowdown in the raising of funds on the Tel Aviv Stock Exchange. These trends occurred even though the Bank of Israel has adopted an accommodative monetary policy, with the goal of supporting business activity and moderating the liquidity shortages that are restraining economic growth. Against this background, the question arises as to whether there is an effective constraint on the business sector's sources of financing that is liable to negatively affect its real activity.

Various surveys indicate that there was a small decline in the share of companies reporting a severe constraint on the availability of financing in 2013, a proportion that had increased since mid-2011. The current financing constraint is greater than it was in 2010 even though the interest rate and yields in the market have fallen since then; nonetheless, this is still a significantly lower constraint than those that prevailed during the worsening of the global financial crisis in late 2008 and during the recession that developed in the first half of the previous decade. In addition, the reported financing constraint in most industries is less severe than other constraints on the expansion of business activity.

In 2013, companies reported a slight decline in the financing constraint they face.

The relatively minor effect of financing difficulties on companies' activities likely derives from the weak level of demand relative to the past and companies subsequently reducing the utilization of physical capital, which has moderated their need for investment (see the discussion in Chapter 2). Furthermore, in 2013, as will be seen below, companies had large cash flows from operating activity and at the same time they increased their equity issuances. In contrast, credit to the business sector declined as a result of the reduction in bank credit while the increase in loans from institutional investors only partly offset that reduction. The prices of credit can provide an indication of the nature of the decrease in credit to the business sector, i.e., whether the cause lies on the supply side or the demand side. A downward shift in the credit supply curve is expected to result in a decrease in the amount of credit and an increase in its price while a downward shift in the demand curve for credit is expected to result in a reduction in the amount of credit and a decrease in its price.[13] As will be seen below, although the quantity of credit has decreased both from banks and in the market for corporate bonds, the price of credit has also fallen and this is evidence that the decline in credit is primarily the result of weak demand. With respect to the supply side, it appears that the obligation imposed on the banks to increase their capital adequacy did not constitute an effective constraint on their supply of credit. Thus, four out of the five major banking groups already reached a core capital ratio of more than 9 percent in the third quarter of 2013, which is earlier than the target date required by the timetable specified by the Supervisor of Banks. Yet, at the same time, considerations of risk management and constraints on the banks' exposure to

The decline in the price of business credit in 2013, in parallel with a decline in its quantity, indicates that the reduction of credit derived mainly from a slowdown in demand.

[13] The price of banks' credit is estimated as the spread between the interest rate on banks' credit and the interest rate paid by the banks on deposits. The price of credit in the corporate bond market is defined as the difference between the yield on corporate bonds and the yield on government bonds.

large borrowers and to business groups affected the composition of bank credit to the business sector.

Financing sources of the business sector

Various theoretical models indicate that information and agency problems are liable to prevent the implementation of investments with a positive net present value. According to these models, the cost of raising debt/equity capital externally is higher than the cost of internal capital since investors demand a premium for the information asymmetry in favor of the company or because they do not have full control over the use made of the funds and are concerned about being taken advantage of by managers.[14]

1. Internal sources

Strong cash flow from operating activities enabled public companies to finance their activities with less dependence on raising debt or equity.

During the last four quarters[15], publicly traded nonfinancial companies in Israel[16] recorded an increase both in net income as a percentage of the total balance sheet and in aggregate net cash flow from operating activities as a percentage of the total balance sheet. This increase was a continuation of a similar trend in the previous year. The increase during these two years was a result of growth in the aggregate profit and cash flow of publicly traded companies, as well as the decline in their total balance sheets. While profit as a proportion of the total balance sheet is near its long-term average, aggregate cash flow as a proportion of the total balance sheet (5.3 percent) and aggregate undistributed cash flow as a proportion of the total balance sheet (4.3 percent) are at historically high levels. As a result of the increase in companies' earnings and the relative stability in distributed dividends and their proportion of the balance sheet, an increase has also been seen in retained earnings during the past two years and in their proportion of the total balance sheet, although their level is still relatively low.

The aggregate net cash flow from current activity of publicly traded nonfinancial companies totaled NIS 89.5 billion during the last four quarters and constituted 63 percent of total nonresidential fixed capital formation in 2013. Cash flow from

[14] See for example:

Myers, S. and Majluf, N. (1984), "Corporate Financing and Investment Decisions when Firms Have Information the Investors Do Not Have", NBER Working Paper Series, No. 1936.

Jensen, M. (1986), "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers", The American Economic Review, Vol. 76, No. 2, 323–329.

Jensen, M. and Meckling, W. (1976), "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", Journal of Financial Economics, Vol. 3, 305–360.

[15] The accounting data that follows relates to the last quarter of 2012 and the first three quarters of 2013.

[16] All publicly traded companies which are classified by the Tel Aviv Stock Exchange as not belonging to the financial industry. The analysis also includes holding companies, and since their financial statements are affected by the financial figures of their subsidiaries there is double counting of some of the companies in the economy. A discussion of this issue, and the way in which it restricts the analysis of publicly traded companies in Israel, appears in Zalkinder, H, N. Steinberg and R. Stein (2012), "A Suggested Methodology for Analyzing Stock Price Levels", Periodic Papers 2012.03, Bank of Israel.

operating activities, not including dividends, totaled about NIS 72 billion during the last four quarters, representing about 51 percent of total nonresidential fixed capital formation in 2013.

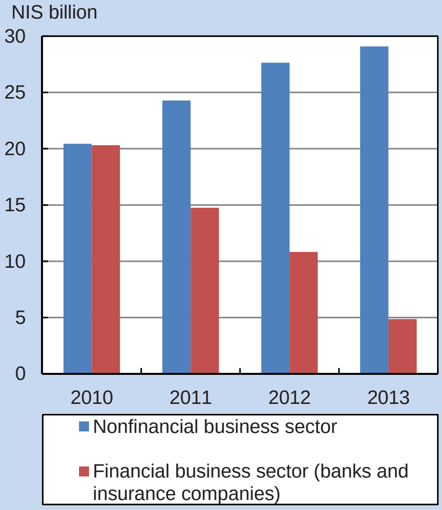
To the extent that publicly traded nonfinancial companies provide an indication for all companies, or at least the largest ones, it can be said that the relatively high level of cash flow from operating activities allows the companies to finance their current activity and to carry out investments with relatively low dependence on external raising of debt or equity.

2. Credit

Credit to the business sector declined in 2013, as a result of a decline in all sources of funding other than loans from institutional investors, which continued to increase this year as well.

Companies in Israel have four main sources of credit (Table 4.3): banks, the capital market, loans from institutional investors and loans from abroad. Total credit to the (nonfinancial) business sector from all sources declined by 2 percent in 2013 compared with 2012. Bank credit (excluding bonds) declined this year by 3.5 percent, in parallel to the decline in the bank interest rate to the business sector and the spread between it and the interest rate on deposits (Figure 4.8); credit from abroad (excluding bonds) declined by 4.2 percent in shekel terms, as a result of the strengthening of the shekel; and credit from the capital market, which is made up of tradable and non-tradable bonds, declined by 2.3 percent during the past year, in parallel to the decline in yields and spreads (Figure 4.7). In contrast, loans from institutional investors increased this year by about 31 percent, following similar increases in 2011 and 2012, though they account for a small proportion of both total credit to the business sector and the total assets of institutional investors (Table 4.3).

Figure 4.6
Corporate Bond Issues (Tradable and Nontradable, Excluding Structured and Convertible), Financial and Nonfinancial Business Sector, 2010–13



SOURCE: Based on Tel Aviv Stock Exchange.

The gross volume of bond issuances in the nonfinancial business sector increased in 2013, simultaneously with the freeing up of sources of credit due to the reduced gross volume of bond issuance by the banks.

The gross volume of corporate bond issues in the nonfinancial business sector has increased since 2010 (Figure 4.6). However, as in 2012, this was less than the volume of redemptions and therefore the total outstanding balance of bonds in the nonfinancial business sector has declined, accompanied by an increase in the proportion of tradable bonds (Table 4.3). This is in spite of the decline in yields in the corporate bond market, which lowered the cost of raising debt. The increase in total gross issuances in the nonfinancial business sector occurred simultaneously with the freeing up of sources of credit in recent years due to the reduced gross volume of bond issuance by the

Table 4.3
Business sector debt (excluding banks and insurance companies) by fundraising channels, (NIS billion, current prices), 2008–13

	2008	2009	2010	2011	2012	2013
Total debt to banks[a]	415	390	412	408	404	388
of which: tradable bonds	4	3	3	3	4	2
Total debt to institutional investors	157	140	135	149	153	151
of which: loans[b]	12	15	18	26	35	45
Total debt to the financial sector	**571**	**530**	**546**	**557**	**557**	**540**
Total debt to nonresidents	126	130	129	148	150	145
of which: loans	93	103	104	126	131	126
Directed credit from the government	5	4	5	4	5	4
Tradable bonds held by households and others[c]	41	72	82	77	83	90
Total debt to all lenders	**743**	**735**	**762**	**786**	**795**	**779**
Loans	520	509	536	561	572	561
Tradable bonds	166	177	185	185	185	186
Nontradable bonds	57	49	41	40	38	32
CPI-indexed	272	265	264	259	263	259
Foreign currency indexed	220	209	204	226	220	203
Unindexed	250	262	294	301	312	317

a Israeli residents only. Solo figures include foreign branches but do not include foreign subsidiaries.

b Including loans from credit card companies that are not the responsibility of, nor are guaranteed by, the banks.

c "Others" are business and financial companies.

SOURCE: Bank of Israel.

banks (Figure 4.6). This is apparently due to the limits put in place by the Supervisor of Banks regarding the possibility of including subordinated debt notes issued by the banks as part of core capital. As a result of the reduction in bond issuance by the banks, the proportion of high-rated bond issues declined.

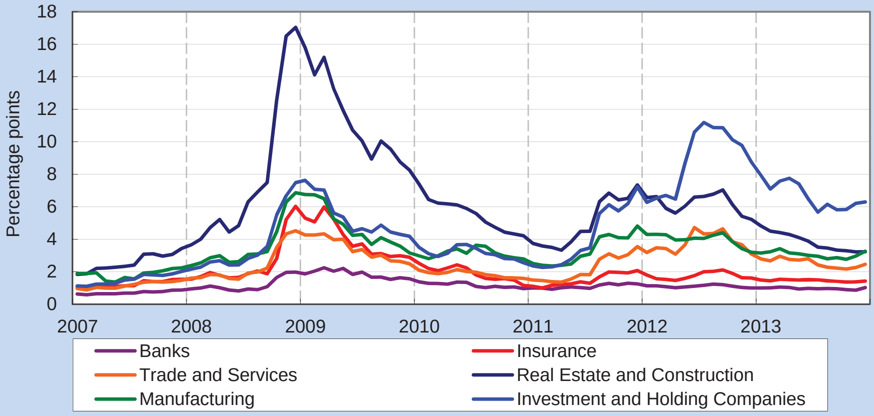
In 2013 there was a significant increase in debt which entered restructuring proceedings, involving a small number of companies with high levels of debt. Since 2009, 108 companies have entered into a debt restructuring proceeding. This involved debt with a total value of NIS 38 billion (before the debt was restructured), which represents about 13 percent of total tradable debt at the end of 2013. About one-quarter of these companies were still in the midst of the restructuring process at the end of 2013[17] and most of them are in the real estate industry.

The yield spreads on corporate bonds narrowed in 2013, against the background of increased public investments in mutual funds investing in these bonds, alongside a decline in the inventory of bonds.

The yield spreads on corporate bonds narrowed during the year and they are at low levels relative to the last two years. At the same time, the public increased its holdings of these bonds through mutual funds. Especially notable is the narrowing of spreads of BBB-rated corporate bonds, which declined by about 13 percentage points at the beginning of the year to about 6 percentage points at the end of the year. The breakdown by industry presents a non-uniform picture (Figure 4.7): there was

[17] Including companies for which this is not the first restructuring during this period.

Figure 4.7
Spreads Between the Monthly Weighted Average of Yields on CPI-Indexed Corporate Bonds (Excluding Structured and Convertible) and the Monthly Average of Yields on Parallel Government Bonds, by Industry[a], 2007–13



[a] As of 2012, the yield gap in the manufacturing industry is calculated excluding "Israel Petrochemical Enterprises Ltd." and "Oil Refineries Ltd." because those companies are characterized by exceedingly high yields compared to the other companies in the industry and bias the industry yield upwards.
SOURCE: Bank of Israel.

a decline or lack of change in spreads in most of the industries while there was an increase in spreads in the manufacturing and the trade and services industries during the second half of the year.

The narrowing of the corporate bond spreads, relative to the yields on parallel government bonds, apparently reflects a decline in the credit risk premium of companies in the economy. However, it is possible that it also reflects an increase in the number of bonds for which financial covenants are defined and collateral is provided, following the recommendations of the Committee to Determine Parameters for Reference by Institutional Investors that Provide Credit through the Purchase of Non-Government Bonds (the Hodek Committee).[18] The narrowing of the spread in 2013 was also supported by mutual funds which invest in corporate bonds benefiting from a high level of net inflows, simultaneous with the reduction in the inventory of bonds.

In addition to the narrowing of the spreads, the decline in yields on government bonds also continued this year and together they reflect a decline in the level of yields on corporate bonds. The low level of yields makes it possible for large companies to raise tradable debt at very low cost and thus strengthens their ability to invest and to expand activity. It also enables them to roll over debt at a low cost and thus improve their stability. Nonetheless, the net volume of issues by companies was negative, which may be evidence of only moderate demand for credit in the corporate bond market.

Despite low yield levels, the negative net volume of corporate bond issues may be evidence of only moderate demand for credit in the corporate bond market.

[18] For further details on this subject, see Dror, N. (2013), “Three Years of the Implementation of the Hodek Committee Recommendations”, at www.tase.co.il (in Hebrew).

3. Equities

There were four initial public offerings (IPO) in 2013, in contrast with 38 companies that were delisted. The total volume of shares issued was lower than the long-term average.

Equities issued on the Tel Aviv Stock Exchange totaled about NIS 6.2 billion in 2013. The total volume of issues was high relative to its level in 2012 (when it was only about NIS 3.5 billion) and somewhat lower than the average volume of issues during the period 2008–13. The total volume of issues was also lower than its long-term average during the period prior to the global crisis in 2008 (i.e., 1993–2007), which was about NIS 10 billion in 2013 prices. There were four initial public offerings (IPO) this year, which accounted for about 5 percent of issues this year; while in contrast, 38 companies were delisted.

Equities issued in the real estate and manufacturing industries accounted for about 70 percent of total equity issues in each of the last three years.

A breakdown of issues by industry shows that the real estate and manufacturing industries have accounted for a major portion of total share capital issued in recent years. These two industries accounted for about 70 percent of total equity issues in each of the last three years (2011–13). The considerable use of equity issues by the real estate industry is due to the fact that it is a capital intensive industry and that it has grown faster than other industries. It is possible that in 2013 it was also due to the decline in bank credit to the industry. With respect to the manufacturing industry, most manufacturing companies that issued on the Tel Aviv Stock Exchange in 2013 belong to the high tech and biomed categories and are young companies. In other words, they are not yet able to provide collateral to receive bank or nonbank credit and therefore they choose to finance themselves by issuing equity. This is also the reason that in contrast to the real estate industry, which is also characterized by a relatively large volume of corporate bond issues, the proportion of the manufacturing industry in corporate bonds is relatively small and composed primarily of traditional manufacturing companies.

The P/E ratio is high, both due to the drop in corporate profits and due to the increase in stock prices.

Stock prices increased in 2013, while corporate profits fell. This led to an increase in the pricing ratios in the economy,[19] which are at a high level relative to the average for the past decade. Thus, the historic P/E ratio of the Tel Aviv 100 Index rose to 19.6 in 2013.[20] Its relatively high level is primarily the result of the drop in corporate profits, while the increase in prices, which was reinforced by the drop in yields on

[19] An additional factor behind the increase in the pricing ratios involves the changes in the composition of the indices and the weights of the companies that make them up. In particular, "Opko", which has a high market value relative to its accounting figures, was listed for trading on the Tel Aviv Stock Exchange and its share was incorporated within the leading indices.

[20] The calculation of the P/E ratio is based on market value, without adjustment for distributed dividends. The ratio of enterprise value to earnings before interest and taxes (EV/EBIT) is based on the market value adjusted for liabilities, minority rights and cash and therefore it is less sensitive to a company's dividend policy. In the case of nonfinancial companies, this ratio was at a level of 21.66 at the end of 2013, somewhat less than its historical average. A description of the calculation of aggregate financial ratios appears in Zalkinder, H., N. Steinberg and R. Stein (2012), "A Suggested Methodology for Analyzing Stock Price Levels", Periodic Papers 2012.03, Bank of Israel.

government bonds,[21] had only a small effect on the ratio. When compared to other countries, it appears that the P/E ratio of the Tel Aviv 100 Index has moved in parallel with the P/E ratios of the main share indices in the developed countries and with the decline in the P/E ratio of the MSCI Emerging Markets Index and is located in the midrange of the ratios for developed market indices.

4. SECONDARY MARKET AND FINANCIAL INTERMEDIATION

a. Regulation

In recent years, regulators have taken a series of steps to strengthen the capital market. The concentration law is expected to reduce the systemic risk in the economy and may even reduce the business sector's borrowing costs.

Appropriate regulation can mitigate frictions that occur in the capital market due to information asymmetry and/or agent problems; thus, it may contribute to the allocation of resources in the economy while reducing costs and enhancing market stability. In recent years, regulators have taken various steps to improve stability, competition, and investors' confidence in banks, institutional investors, and the capital market. These measures include the establishment of a team to seek ways of increasing competitiveness in the banking industry (the Zaken Committee),[22] the appointment of a committee on financial institutions' investment in corporate bonds (the Hodek Committee), the creation of a committee on financial institutions' investments in direct loans (the Goldschmidt Committee), the legislation of the Administrative Enforcement Law, the toughening of restrictions on transactions with related parties (Amendment 16 of the Companies Law), restrictions on senior officers' wages (Amendment 20 to the Companies Law and Proper Conduct of Banking Business Directive 301), and the formation of a committee for the examination of debt restructuring proceedings (the Andorn Committee).

In addition, the Knesset passed the Promoting Competition and Reducing Concentration Law. By reducing concentration and restricting pyramid structures, the provisions of this statute are expected, *inter alia*, to alleviate the moral hazard problem that arises in taking credit and facilitate the monitoring of borrowers by reducing the intricate relationships that exist among the public companies of which the pyramids are composed. In this respect, the measures are supposed to reduce the business sector's borrowing costs. The law also empowers the Minister of Finance and Governor of the Bank of Israel, or their agents, to set limits on the total credit that may be issued to a corporation or a business group by financial entities on a cumulative basis. This is expected to prevent overleveraging of corporations and business groups and mitigate the systemic risk that originates in the existence of large and leveraged corporations and, foremost, large and leveraged business groups.

[21] The yield on government bonds, which is perceived as riskless, is used as the alternative rate of interest for the riskier investment in shares. Similarly, it is used as a benchmark for the discount rate (which also includes a risk premium) in the asset pricing model. Therefore, a decrease in their yields contributes to an increase in the value of companies and the P/E ratio.

[22] For details on the team's recommendations, see Chapter 4 of the Bank of Israel Annual Report for 2012.

Capital market regulation creates direct and indirect costs for public companies, institutional investors, and private investors. Insofar as these costs are not essential and not conducive to financial stability, they create a disincentive for companies to be public and make trading on the stock exchange less accessible to investors. It is likely that they contributed indirectly to the decline in activity on the stock exchange (see Box 4.1 of the 2012 Bank of Israel Annual Report). Against this background, the Israel Securities Authority (ISA) published a document that listed targets for the easing of regulations, including the elimination of redundancies in corporate reporting, the standardization of types of reporting, extending the validity of shelf prospectuses to thirty-six months, and alleviation of regulatory requirements applying to small firms, among others. The ISA also set up a committee to promote investments in public corporations that are active in research and development, whose purpose was to promote the funding of high tech companies by means of the stock exchange by easing the regulation of appropriate firms.

b. The Tel Aviv Stock Exchange

Stock trading volumes on the TASE rebounded somewhat in 2013.

In recent years, the Tel Aviv Stock Exchange has seen a protracted decline in trading turnover in shares relative to earlier years and relative to turnover in foreign exchanges.[23] The trend continued in the first half of 2013; in the second half of the year, daily trading volumes rebounded somewhat but remained far below their peak in 2010. The recovery—like the behavior of stock prices—coincided with an increase in trading volumes abroad. It was also evident in trading volumes in both par value and share turnover, meaning that it did not originate in the increase in share prices. This, however, was true mainly of the Tel Aviv 100 Index and the General Shares Index but not of the Tel Aviv 25 Index. This indicates that trading turnover in blue chip equities, which account for most holdings of foreign investors, increased to a smaller degree. If so, the prolongation of hours of activity at the Tel Aviv Stock Exchange (TASE), a measure meant to widen the overlap with American trading hours in order to stimulate nonresident activity, probably had only a limited effect.

The low turnover in trading in shares and the concurrent protracted decrease in trading in derivatives have a negative impact on the liquidity and efficiency of the secondary market and, for this reason, are indirectly detrimental to the primary market as well. Against this background, in 2013 the ISA initiated the establishment of a committee to examine ways of increasing trading volume. The committee's interim report made the following salient recommendations, *inter alia*: consider the possibility of reorganizing the TASE as a for-profit corporation; expand the types of memberships on the TASE; create a centralized digital pool of lendable securities at the TASE clearing house and give all players in the capital market access to it; and encourage algorithmic trading while mitigating its intrinsic risks.

[23] For elaboration, see Box 4.1 in the 2012 Bank of Israel Annual Report.

Some of the recommendations may improve liquidity in the stock market and help domestic firms raise capital via the TASE. Other recommendations, however—such as those pertaining to trade in new financial products that are unrelated to shares—relate to other domains and are unlikely to have a salutary effect on liquidity in the share market. Two recommendations in particular carry remarkable risks that may overshadow their possible contribution for liquidity in the secondary market. (a) The recommendation to allow banks to serve as market makers is problematic because any increase in banks' involvement in trading in shares poses risks to the stability of the banking system and the financial system at large. This was one of the lessons of the Israel's bank-share crisis that erupted in 1983 and of the global financial crisis that erupted in 2008. Furthermore, given the centrality of banks in Israel in credit, underwriting, brokerage, and consultancy, the recommendation places the banks in a structural conflict of interest between their position as market makers and the wellbeing of their business and private customers; it may also exacerbate economic concentration. (b) The recommendation to lower the rate of capital gains tax carries a potential fiscal cost; in 2013, this tax generated NIS 3.5 billion in revenue. Furthermore, although this recommendation does refer to the potential effect of lowering the tax on capital gains on activity in the capital market, it overlooks the potential impact of this measure on other activities and on the distribution of income in the economy.

Liquidity in the corporate bond market remained relatively low in 2013.

In contrast to the shares and derivatives market, average daily trading volume in indexed and nominal government bonds remained strong in 2013 at around NIS 1 billion and NIS 1.6 billion, respectively, much as in 2012. Trading volumes in corporate bonds were lower, at NIS 0.7 billion in 2013, basically unchanged from 2012. Liquidity in the corporate bond market was typified by even lower trading cost[24] than had existed before the deterioration of the 2008 crisis, although higher than trading costs in the government-bond and *makam* markets. In contrast, market depth[25] in corporate bonds has not yet rebounded from the 2008 crisis; the average transaction size and quoted quantity in 2013 were only one-third and one-fourth, respectively, of their levels at the beginning of 2008. The *makam* market slumped in the second half of 2013, with trading volumes and market depth declining considerably and trading costs inching up. This followed the recovery of the *makam* market in 2011 and 2012 from an exit of nonresidents in which nonresidents' share in the market declined sharply from 35 percent to near 0. (For elaboration, see Chapter 7 of the 2012 Bank of Israel Annual Report.)

c. Banks as financial intermediaries

1. General

The ratio of bank credit to GDP sank to its lowest level in a decade.

In 2013, total gross bank credit (credit before credit losses) increased by a moderate 2 percent and the ratio of bank credit to the public (balance-sheet credit) to GDP

[24] Trading cost is measured in terms of the bid/ask spread in the orders book.
[25] Reflected in average transaction size and average quoted quantity.

sank to 79.5 percent, the lowest level in a decade. In the past decade, total bank credit increased by 42 percent, slower than the upturn of 73 percent in credit from institutional investors, although the share of the latter in total credit (28 percent) remained lower than that of the former (44 percent). In recent years, the Supervisor of Banks has toughened the banking system's capital adequacy requirements to enhance the system's stability. Thus, in March 2012 the Supervisor instructed all banks to increase their core capital ratio to 9 percent by the beginning of 2015 and ordered the two largest banks to continue increasing it to 10 percent by the beginning of 2017. Indeed, the banks' ratio of core capital to risk assets has increased by 16 percent since the end of 2009. As noted, however, most of the large banking groups had already attained a strong 9 percent core-capital ratio by the third quarter of 2013, ahead of the Supervisor's deadline. Accordingly, the steeper capital adequacy requirements do not appear to have posed an effective constraint to an increase in bank credit in 2013.

Bank credit to business customers declined, apparently as a result of a decline in demand for credit.

Bank credit to business customers[26] was NIS 388 billion in 2013, down 3.7 percent. Figure 4.8 presents an estimate of interest on the public's bank deposits, interest on bank credit to business customers, and the spread between interest on bank credit to business customers and the interest that the banks pay the public for its deposits. The figure shows that against the background of the declining monetary interest rate and yields in 2013, interest on deposits also declined. Concurrently, the estimated spread between estimated interest on business credit and interest on deposits narrowed to less than 1 percent in the review year. As a result of the decrease in interest on deposits, and the narrowing of the spread for business customers, the estimated interest rate to business customers fell in the third quarter of 2013 to its lowest level since 2009. The contraction of the credit spread for business customers suggests that the decrease in the volume of bank credit to business customers reflected decline in the demand for credit and not a stronger supply constraint. Furthermore, an increase in unutilized credit lines in 2013—admittedly a small upturn relative to the concurrent decline in total bank credit to business customers—may indicate that domestic firms had unutilized potential sources of credit. This suggests that their funding needs had declined, giving evidence of sluggish demand.

In recent years, the banks have reduced their exposure to large borrowers, while simultaneously increasing credit to small businesses.

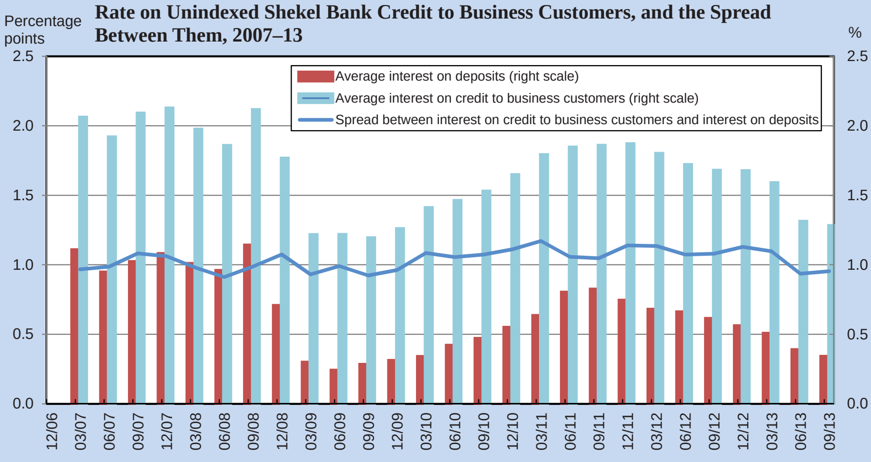
In the first half of 2013, the banks continued to reduce their exposure to large borrowers[27] after reducing their lending to such borrowers by 3 percent in 2012. The decrease was occasioned, among other things, by a series of measures by the Supervisor of Banks in 2011 that tightened the restrictions on banks' exposure to large borrowers and large business groups. A second factor concerned the difficulties that some large business groups and their controlling shareholders have encountered in recent years. However, large firms are able to tap alternative sources in the capital market, from sources abroad, or directly from institutional investors. Small and

[26] "Business customers" are the composite of large firms (business sector), medium enterprises (commercial sector), and small businesses.

[27] See Israel's Banking System—First Half of 2013.

medium enterprises, in contrast, rely mainly on bank credit to finance their activity.[28] The extent of bank credit to small businesses, however, has actually been increasing in recent years, by 6 percent on average in 2010–12. Furthermore, in April 2012, the government established a new fund for guaranteed bank loans to SMEs, triggering a rapid increase in secured lending to such enterprises. In 2013, these loans added up to NIS 2 billion, more than 1 percent of total bank credit to businesses in this class.

Figure 4.8
Estimates[a] of the Interest Rate on the Public's Deposits with Banks, the Interest Rate on Unindexed Shekel Bank Credit to Business Customers, and the Spread Between Them, 2007–13



[a] The interest on the public's deposits is estimated as the ratio between income from interest on shekel deposits and the average balance of shekel deposits, and the interest on credit is estimated as the ratio between income from interest and fees on shekel credit to business customers and the average balance of shekel credit to those customers. The interest rate spread reflects the spread between the estimated interest on credit and the estimated interest on deposits.
SOURCE: Bank of Israel.

2. Analysis by industry

Credit to the manufacturing industry stabilized in 2013, after declining almost continuously from 2008 to 2012. The decrease in bank credit to the business sector in 2013 was focused on construction and real estate, after previous years of consistent strong increases in lending to this industry.

Credit to the manufacturing industry stabilized in 2013 after declining almost continuously since 2008. In contrast, credit to the construction and real estate industry declined, but it seems that this does not reflect a supply constraint.

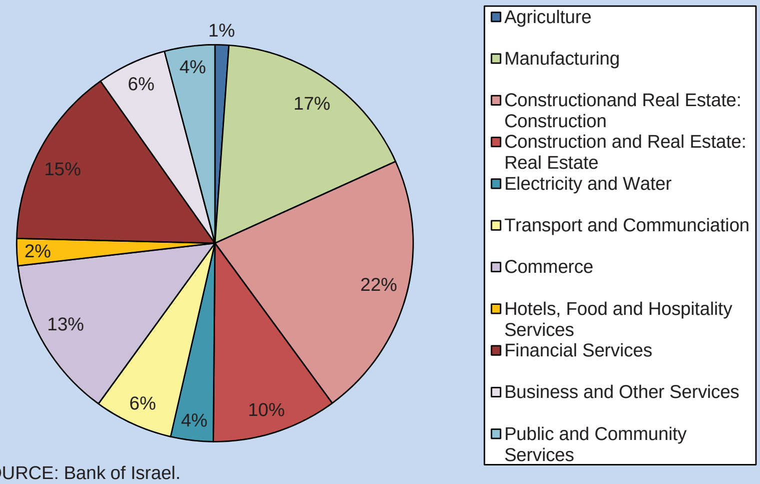
The question is whether the downturn in bank credit for construction and real estate reflects weak demand for credit due to the slowdown in activity and investment in this industry in 2013, or whether it reflects a constraint in the supply of bank credit to the industry. Construction and real estate is the largest industry in the banks' business credit portfolio; some banks are indeed near the industry-specific indebtedness limit.[29] The system at large, however, is still far from the limit and, accordingly, could have

[28] According to an OECD report, small and midsized enterprises in Israel derive more than 80 percent of their credit from the banking system (Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard, January 2014).

[29] When total indebtedness of a specific industry to a banking corporation exceeds 20 percent of total public indebtedness to that corporation, the industry's debt in excess of the limit is considered excess debt.

lent more to this industry. Furthermore, the entire decrease in credit to the construction and real estate industry in 2013 originates in less lending to the real estate industry, which enjoyed narrower spreads and made larger offerings in the nonbank market in the review year. Bank credit for construction—an industry typified by smaller firms that have few alternatives to bank credit—actually increased in 2013. If so, a supply constraint to credit to the construction and real estate industry does not appear to have weighed on their activity in 2013; in particular, a shortage of credit does not appear to have thwarted an increase in residential construction.

Figure 4.9
Distribution of Bank Credit to Businesses, by Industry, September 30, 2013



SOURCE: Bank of Israel.

d. Institutional investors as financial intermediaries

Institutional investors reduced their corporate bond holdings.

Total assets under management by institutional investors were NIS 1.2 trillion at the end of 2013, up 10.5 percent from the previous year. Some 44 percent of assets were invested in government bonds. Total institutional holdings of corporate bonds decreased by 5 percent in 2013—after having trended upward since 2009—despite rising bond prices, in view of negative net corporate bond issues, the implementation of the Hodek Committee recommendations, debt settlements in response to defaults, and institutional investors' direct lending to the business sector. Although direct loans account for only 5 percent of assets managed, this component of the institutions' activity has been increasing rapidly in each of the past few years.

There are advantages to direct loans from institutional investors to companies, but such loans also come with risks. The Commissioner of Capital Markets established a committee with the aim of dealing with these risks.

Given the restrictions imposed following the Hodek Committee recommendations, and the rapid growth of institutional investors' assets, these investors' direct lending to business borrowers has been expanding rapidly. Some loans of these types are issued to companies directly; others take place through the acquisition of credit portfolios from banks. Banks use this channel of activity to reduce their credit inventories in order, *inter alia*, to comply with compulsory capital ratios; institutional investors use it in order to take advantage of the banks' ability to underwrite credit portfolios. These advantages, however, come with risks: the sale of bank loans to institutional investors may expose the latter to hidden risks due to their information asymmetry vis-à-vis banks regarding the loans' and borrowers' quality and because the sale may impair the banks' incentive to monitor the loans properly.

In 2013, the Commissioner of Capital Markets at the Ministry of Finance received the interim report of a committee that had been appointed to investigate the way institutional entities invest in "coordinated" loans (the Goldschmidt Committee). The committee took a favorable view toward institutional investors' entry into direct lending, particularly because the public is placing more and more of its savings with these institutional investors. The committee's recommendations in regard to corporate governance require institutional investors to establish criteria for credit review, supervision, and control, but they leave it to the institutional players to determine the level of the criteria by themselves. Additional recommendations pertain to the management of information about borrowers, the performance of analysis, the regularization of relations with other parties in co-lending transactions, the responsibilities of the Commissioner of Capital Markets, and disclosure requirements (which are chiefly a general report in the financial statements and detailed information submitted only to the Commissioner of Capital Markets).

5. THE FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS

The deficit in the financial account continued in 2013, and balanced the surplus in the current account.

The financial account of the Balance of Payments remained in deficit in 2013 and balanced the surplus in the current account. (For elaboration on the current account, see Chapter 2.) In the first two quarters of 2013, sizable investments were made by nonresidents in Israel and by Israeli residents abroad. In the third quarter, due to concerns about tapering in the US and a temporary increase in Israel's geopolitical risk, nonresidents' investments waned slightly while residents' investments abroad continued to grow but less vigorously. In the fourth quarter, nonresidents again increased their investments in Israel and Israeli residents ramped up their investments abroad considerably (Table 4.4).

The outflow of residents' investments reached a six-year high in 2013.

The outflow of residents' investments, not including reserve assets, reached a six-year high in 2013. The increase in residents' investments abroad in 2013 derived mainly from $11 billion in financial investments in tradable securities—$6.5 billion in stocks and the rest in tradable bonds—along with $5 billion in direct investment, nearly all in shares. There was also a $4.4 billion increase in Israeli reserve assets abroad, i.e., in the Bank of Israel's foreign exchange reserves. This happened because the Bank of Israel resumed foreign currency purchases and implemented a program of foreign currency purchases to offset the effect of natural gas production on the exchange rate (see Chapter 3). Net other investments abroad by Israeli residents were positive in the first two quarters of 2013 but turned negative in the third quarter as

Table 4.4
Nonresidents' investments in Israel and Israeli residents' investments abroad, by investment type, 2010–13

(net transactions, $ million)

	Year				Quarter			
	2010	2011	2012	2013	2013:Q1	2013:Q2	2013:Q3	2013:Q4
1. Nonresidents' investments in Israel	**18,171**	**7,139**	**2,321**	**12,212**	**4,917**	**5,595**	**-444**	**2,145**
Direct investment in Israel	5,510	10,766	9,481	11,803	3,511	4,782	1,985	1,525
Financial investment in tradable securities	8,985	-5,658	-3,513	1,627	1,739	384	-1,512	1,017
Other investments in Israel	3,677	2,031	-3,648	-1,219	-334	429	-917	-397
2. Israelis' investments abroad excluding reserve assets	**17,778**	**8,816**	**8,594**	**19,271**	**5,366**	**5,116**	**880**	**7,909**
Direct investment abroad	8,656	5,329	2,352	4,933	417	1,105	2,274	1,137
Financial investments in tradable securities	9,369	3,120	8,778	11,005	4,043	1,584	2,967	2,411
Other investments abroad	-217	354	-2,240	3,777	1,060	2,549	-4,260	4,428
Derivative instruments	-30	12	-296	-444	-153	-123	-101	-67
3. Net financial account excluding reserve assets (1-2)	**393**	**-1,677**	**-6,273**	**-7,059**	**-450**	**479**	**-1,324**	**-5,764**
4. Reserve assets	**11,912**	**4,534**	**-180**	**4,357**	**1,754**	**1,130**	**378**	**1,095**
5. Net financial account (3-4)	**-11,520**	**-6,211**	**-6,094**	**-11,416**	**-2,204**	**-651**	**-1,702**	**-6,859**

SOURCE: BOI and based on Central Bureau of Statistics.

domestic banks liquidated deposits at foreign banks and Israeli residents reduced commercial credit to customers abroad. The decrease mirrors the downturn in exports that was recorded in the third quarter (see Chapter 2).[30] In the fourth quarter, net other investments abroad by Israeli residents turned positive again, primarily as a result of an increase in customers' credit, in view of the increase in exports.

The growth in institutional investors' investments abroad did not apply direct depreciation pressure on the shekel, due to hedging.

The share of managed assets that institutional investors allocate to investment in foreign assets abroad increased by 3 percentage points in 2013 and accounted for 20.8 percent of total assets. This rate has been rising quickly since the 2003 tax reform and has more than doubled since 2006 while domestic financial assets increased less than the volume of assets that institutional investors managed. Investment abroad helps to diversify investment in assets and, therefore, may help to mitigate risk. It also creates a foreign-currency exposure, leaving it to the institutional investors to choose whether—and to what extent—to hedge it in order to balance between (a) the wish to index some long-term savings to foreign currency so as to maintain the future purchasing power of imported goods and services, and (b) the exchange-rate risks that are inherent in an excessive exposure to foreign currency. In practice, in 2011

[30] There is a 59 percent correlation between commercial credit flows to customers abroad and changes in exports (excluding startup enterprises and diamonds). (See Chapter 2).

and 2012 institutional investors increased their overseas investment without hedging, whereas in 2013 they hedged their entire investment outflow and even more, much as they did in 2009–10, a time when institutional investors hedged most of their foreign investment flow. Thus in 2013, unlike the previous two years, institutional players' investments abroad did not apply direct depreciation pressure on the shekel.

The inflow of nonresidents' direct investment in Israel reached a seven-year high in 2013.

In 2013, the increase in investment in Israel by nonresidents was mostly direct investments—growing to $11.8 billion, the largest upturn in any year since 2006. In 2012 (the last year for which internationally comparable data exist), the direct investment inflow was 3.9 percent of GDP as against 1.2 percent on average among OECD countries. Most of the increase in 2013 (59 percent) belonged to net investment in shares ($6.2 billion); the remaining 41 percent traced to undistributed profits that accumulated in 2013. Some 64 percent of net acquisitions of shares took place in six transactions. Sales of startup enterprises brought in $2.4 billion in 2013, more than twice the long-term average. Nonresidents continued to draw down their holdings of government bonds in 2013 and their *makam* holdings fell to zero. The latter had begun to decline in the middle of 2011 due to the imposition of a reserve requirement on nonresidents' transactions in short-term interest instruments and the abolition of the tax exemption for nonresident investors on interest income from short term investments. (For a discussion of this topic, see the Balance of Payments section of the 2012 Bank of Israel Annual Report.) The contraction of nonresidents' holdings of short term portfolio investment instruments caused short term pro-appreciation forces to abate. In contrast, the continuation of large scale foreign direct investment with no hedging of the NIS exposure remained a basic pro-appreciation factor.