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Of Deficits and Debts

GLOBAL AGENDA

By PINCHAS LANDAU

Israel's budget deficit is large and growing rapidly. That's a fact. It's still much smaller than the deficits of not just "the usual suspects" – Greece, Spain, et al – but also of the US and UK. That's also a fact. But what do these facts mean? How is this deficit going to be financed? By borrowing? Surely that creates a danger of "ending up like Greece and Spain." Or does it? What does that threat actually mean?

In the purely financial sense, "ending up like Greece" means that a country loses access to the financial markets – which in turn means that investors are not prepared to lend to it. If no one will lend to the country, it will be unable to pay interest or repay principal on its outstanding debt, and it will "go bust." It will be unable to buy the things it needs and doesn't produce itself, such as food, fuel and medicines. Its citizens will first be "wiped out" financially, then impoverished, and ultimately – if the process goes through to the very bitter end, they will be reduced to starvation. Greece is at the beginning of that process, but there are African countries that have endured most or even all of it. In short, as the contemporary slang has it – "you don't want to go there."

How do you avoid it? Clearly, by not reaching the point where no one will lend to you. But let's be more specific: why would 'they' refuse to lend to you? The answer is simple enough – because 'they' don't believe you can or will repay the loan. The world is now split between countries to which people are not prepared to lend at any reasonable rate of interest, and those they will lend to for nothing or even if it costs them money (negative interest). In a world driven mad by fear of not being repaid, it is essential not to be on the wrong side of that divide.

But why would 'they' trust you? There are two answers, both of them critical. One reflects basic facts and figures. Borrowers have a record, which is public knowledge. Greece, for instance, has spent much of its 182-year modern history in a state of default. On the other hand, Israel, and the Zionist movement that spawned it, has never missed a payment of interest or principal in the 110 years since it started borrowing.

In addition to the historical record are the current data – how large are your debts? In the Israeli case, total debt to the rest of the world is actually negative: the world owes it more than it owes the world. That has been the case for the last ten years or so, and Israel's net creditor status keeps growing. If you didn't know that – and most people don't – then you have a totally distorted view of the Israeli economy. More recently, the asset side of the Israeli balance sheet has received a dramatic and massive boost, thanks to the discovery of large natural gas deposits off the Mediterranean coast.

Knowing that Israel has both the will, and the means, to repay its debts is a powerful incentive for "them" to trust us. But it's not the only one.

Borrowing from 'Them'

To understand the other reason why 'they' should trust 'us,' let's start over. We said that Israel's financial position is fundamentally strong, but it has a short-term problem in the form of a large budget deficit. If we are so strong financially, even net creditors to the world, there should be no problem raising loans in the international markets.

However, the markets themselves have become both panicky and finicky, while the lenders – banks and large financial institutions – have serious problems of their own to deal with. Banks, in particular, are hoarding cash and loath to lend to almost anyone, whether households, businesses or even sovereign countries. In this environment, there is a significant danger that Israel will lose access to the markets not because it is not a good debtor, but because the potential lenders are not good creditors, or simply because the markets themselves have become dysfunctional.

Fortunately, Israel does not have to rely very much on foreign borrowing because it has two other – and arguably better – sources of finance. The first of these is the pool of domestic savings, a source available to almost every government in the world. The second, however, is unique to Israel.

The Israeli public saves a lot - unlike, say, the American public. Ideally, these savings are invested in the private sector, but the government can, and does, borrow some of this money. How much it borrows depends on how much old debt it is rolling over, and how much additional debt it requires – i.e. how big its current deficit is. Clearly, if the government consistently grabs the lion's share of domestic savings, there will be a cumulatively negative impact on the economy – indeed, that is how Israel got into severe trouble in the early 1980s, and how other countries have done the same recently or are doing so currently. But having a pool of domestic savings is critically important.

Israel also has a source of finance and a borrowing instrument unique to it – although quite a few countries would dearly love to have something similar. This source is Diaspora Jewry, and the instrument which Israel uses to borrow from Jews around the world is Israel Bonds. In recent years, when Israel's borrowing requirements have been low, Israel Bonds has chugged along quietly, raising an average $1.1 billion per year. Of this, more than three-quarters comes from individuals, the rest from financial institutions such as pension funds, which appreciate the advantages offered by Israel Bonds – both the security of "return of capital," from a borrower that has never missed a payment, and the attraction of "return on capital", i.e. the reasonable rate of interest offered, especially in the current environment.

In times of crisis, whether geo-political/ security or economic/ financial, Israel Bonds could raise much larger sums, probably double, possibly triple – although it would be preferable not to have to find out. Given that lenders will only lend at all – let alone lend more - if they trust the borrower to repay the loan, it is vital to understand the two reasons why 'they' trust us. One is the normal criteria whereby creditors assess borrowers, and here the historical record of Israel Bonds and the State of Israel, now buttressed by Israel's much stronger overall financial position, speaks for itself.

The other is the feature that makes Israel Bonds unique, probably inimitable. The lenders are not a foreign, remote, impersonal entity, a conceptual "them." "They" are actually "us," an extended family in which, when one branch is in trouble, the others step up to help out.