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Research Update:

Israel 'A+/A-1' Ratings Affirmed; Outlook Stable

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Overview

- We expect the Israeli economy to remain strong despite risks associated with the global economy and international financial markets. Such resilience comes from its diversified economy, strong external position, and flexible monetary framework.
- We are therefore affirming our 'A+/A-1' foreign and local currency sovereign credit ratings on Israel.
- The stable outlook reflects our expectation that the government will maintain stable public finances and continue to tackle structural issues in the economy, and that the impact of security risks on the Israeli economy will be contained over the next two years.

Rating Action

On Aug. 5, 2016, S&P Global Ratings affirmed its 'A+/A-1' long- and short-term foreign and local currency sovereign credit ratings on the State of Israel. The outlook is stable.

Rationale

The ratings are supported by Israel's prosperous and diverse economy, strong external balance sheet, and flexible monetary framework. The ratings are constrained by Israel's high general government debt burden and significant security and geopolitical risks.

With per capita GDP at an estimated $37,000 in 2015, the economy is prosperous and well diversified, with high value-added manufacturing and service sectors. This is underpinned by high expenditure on research and development, amounting to 4.1% of GDP in 2014, the second-highest among member countries of the Organization for Economic Co-operation and Development (OECD). The information and communication sector has a 9.8% share of gross value added (GVA) and scientific and technical activities have 2.8%.

We assume Israel's economy will grow at an average rate of about 2.5% in 2016-2019, despite risks of weaker global demand, partly thanks to a major investment by Intel. We expect the key drivers of this growth will be robust private consumption, continued corporate investment activity, and healthy service exports, supported by both loose monetary policy and continued fiscal stimulus. In per capita terms, this equates to growth of around 1% per year, reflecting robust population growth.

The government recently approved a new development plan for the Leviathan gas field, after the supreme court had blocked a previous deal. We believe the development of Israel's gas resources would benefit the economy and its fiscal position, but further court suits could cause more delays. Moreover, in our view, the lack of gas distribution network infrastructure could also limit how much domestic input cost reduction the gas field could bring to the Israeli economy.

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The March 2015 general elections resulted in a right-wing government coalition with 61 of 120 seats in Israel's parliament, the Knesset. In May 2016, a new right-wing coalition partner, Israel Beitenu, joined in the government, increasing the number of supporters to 66 from 61 and resulting in a more stable coalition. Nevertheless, it also adds to the already heterogeneous coalition structure; hence the inclusion of a new partner is unlikely to enhance the government's capacity to deliver sustainable public finances and measures that boost economic prospects.

We believe infrastructure enhancements, especially to transportation, could support productivity gains that have been lacking in the Israel economy. However, we expect the infrastructure gap to remain, given the capacity and administrative constraints facing the sector. We foresee somewhat muted progress in tackling the other structural issues facing the Israeli economy, given that any controversial measures are unlikely to receive coalition support. Moreover, some previously implemented measures to boost educational attainment and labor supply have been reversed in order to secure support from Ultra Orthodox parties, Shas and United Torah Judaism.

In 2015, the central government deficit was 2.2% of GDP and general government deficit was 2.4% of GDP, a relatively positive fiscal performance arising mostly from better-than-expected tax revenue collection. This trend continued in first half of 2016, which has now given the government confidence to cut taxes. The new coalition government has reached a consensus regarding the biannual 2017-2018 budget, maintaining the deficit ceiling of 2.9%. The new budget envisages expansionary fiscal measures, cuts to personal and corporate income taxes, and increased spending on health, education, and infrastructure. Given the government's reasonable track record of containing fiscal pressures within a stringent framework, and the potential for a snap election should additional parlimentary approval on budgetary matters be required, we expect the general government deficit to remain at 2.9% of GDP over the next two years.

A substantial reduction in interest expenditures in 2015 significantly improved Israel's debt ratios. Amid the low-inflation environment (around one-half of general government debt is CPI linked) and low funding costs, we expect this trend to continue over the forecast horizon. Subtracting liquid assets (mostly in the form of deposits at the central bank) from gross government debt, we estimate that net general government debt remained at below 62% of GDP at the end of 2015. Even without taking into account possible land sales and privatization proceeds, which could reduce government financing needs, we expect the net debt ratio could increase slightly to 64% of GDP in 2019.

As a result of Israel’s strong export performance and sustained current account surpluses, its external balance sheet is strong and its net creditor position versus the rest of the world continues to grow. We forecast that its liquid external assets will outstrip its gross external debt over the next three years. This dynamic is also lowering the country's gross external financing needs, indicating low dependency on external financing.

We also consider Israel's monetary policy flexibility to be a credit strength. The Bank of Israel (BoI, the central bank) has become increasingly interventionist, over and above its commitment to purchase foreign currencies to offset the impact of domestic natural gas production on the balance of payments. We view the exchange rate regime as a managed float, which somewhat hampers monetary policy flexibility.

In addition to making frequent interventions in the foreign exchange market, the BoI has eased its stance on monetary policy, countering the strength of the Israeli new shekel in order to maintain the competitiveness of Israeli exports. It lowered its policy rate to a historical low of 0.1% in March 2015, but the shekel continued to appreciate against Israel's key trading partners. During 2015, the shekel weakened by 0.3% against the dollar, but strengthened by about 7.3% against the currencies of Israel's main trading partners, in terms of the nominal effective exchange rate. Since the beginning of the year, the shekel continued to appreciate vis-à-vis main trading partners.

One of the key challenges to monetary policy continues to be Israel's rising house prices. Real house prices have increased by around 69% since the end of 2007 and the International Monetary Fund (IMF) assesses that the house prices in Israel are currently overvalued by 30%. The BoI's earlier attempt to dampen the housing market by raising interest rates yielded little, and significantly pushed up the foreign exchange rate of the shekel. The government has implemented a comprehensive set of measures to address supply-side issues, including freeing up more land for development, changing the tendering criteria to give first time buyers a discount to market price, and speeding up administrative processes for construction permissions. Given the capacity constraints in the construction industry, the extended time needed to build houses, and continued growth in demand, we do not expect government measures to fully address the supply shortage in the near term. The first half of 2016 saw little impact on supply of housing from these measures; house prices recorded above the 5% annual growth rate in March, however, we understand that house price data currently do not take into account of the aforementioned discount for first time buyers.

The tightening of macroprudential measures has reduced systemic risks to Israel's banking industry and constrains mortgage leading growth, but any meaningful correction in house prices could have other negative economic effects (see: "Banking Industry Country Risk Assessment: Israel," published Oct. 23, 2015, on RatingsDirect). We expect that by the end of 2016 the Knesset will pass general legislation to establish a formal Financial Stability Committee, as recommended by the IMF, to enhance policy co-ordination.

Overall, institutional and governance structures in Israel are generally effective, with a satisfactory degree of transparency and accountability. However, we consider that the persistent territorial dispute with the Palestinians threatens political stability and weighs on policy predictability.

Geopolitical risks continue to weigh on the ratings. Repeated violent clashes with the Palestinians not only inflict social and economic costs, but also elicit negative reaction from the international community. In Israel's neighboring region, the conflict in Syria and Iraq, as well as instability in the Sinai region, pose medium-term security risks. Any significant armed conflict could have a negative impact on the ratings if it significantly deterred investment, weakened the economy's growth potential, or strained fiscal flexibility. We do not expect the nuclear agreement between Iran and the international community to be either positive or negative for Israel over the forecast period, given the continued regional tensions and inherent uncertainty regarding the implementation of the agreement.

Outlook

The stable outlook on Israel reflects our opinion that the government will maintain prudent macroeconomic policies and ensure the stabilization of government debt over 2016-2019, despite higher spending concessions agreed by the coalition. The stable outlook also reflects our expectation that security risks to the Israeli economy will not increase materially.

We could consider raising our ratings if fiscal consolidation exceeds our expectations, or additional income from gas fields sustainably reduces the net debt burden to below 60% of GDP, or if there is marked progress in defusing external security risks.

Conversely, we could lower the ratings if the economic growth outlook were to weaken substantially, due to an abrupt correction in the housing market or unaddressed structural weaknesses. A downgrade would also become more likely if the government yields to pressures for more social or security spending and allows deficits to widen and government debt to increase significantly above our current expectations. Moreover, if a perceived loss of international support were to further isolate the Israeli economy, we could lower the ratings.

Key Statistics

Table 1

State of Israel Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	876	937	1,001	1,056	1,094	1,150	1,185	1,240	1,298	1,359
Nominal GDP (bil. $)	234	262	260	292	306	296	304	318	333	349
GDP per capita (000s $)	31.6	34.6	33.7	37.4	38.5	36.7	37.1	38.2	39.4	40.6
Real GDP growth	5.5	5.0	2.9	3.3	2.6	2.5	2.4	2.5	2.5	2.5
Real GDP per capita growth	3.3	3.0	1.1	1.6	1.0	0.9	0.8	0.9	0.9	0.9
Real investment growth	10.0	14.6	3.6	3.6	(2.0)	(1.0)	4.0	3.0	3.0	3.0
Investment/GDP	18.2	20.2	21.0	20.2	19.9	19.5	20.5	20.8	21.1	21.5
Savings/GDP	21.6	22.8	21.6	23.5	23.9	24.4	24.3	24.6	24.9	25.3
Exports/GDP	35.0	36.1	36.9	33.2	32.3	31.1	30.7	31.1	31.5	31.9
Real exports growth	15.0	8.9	0.9	0.1	1.5	(3.3)	(1.0)	3.0	3.0	3.0
Unemployment rate	8.3	7.1	6.9	6.3	6.0	5.5	5.4	5.4	5.4	5.4
EXTERNAL INDICATORS (%)										

Table 1

State of Israel Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Current account balance/GDP	3.4	2.6	0.6	3.3	4.0	4.9	3.8	3.8	3.8	3.8
Current account balance/CARs	8.0	5.9	1.4	8.3	10.1	12.8	10.2	9.9	9.7	9.5
Trade balance/GDP	(0.8)	(2.9)	(3.5)	(2.4)	(2.2)	(1.1)	(1.6)	(1.7)	(1.8)	(1.9)
Net FDI/GDP	(1.5)	(0.2)	2.0	2.4	1.0	0.5	1.0	1.6	1.2	1.2
Net portfolio equity inflow/GDP	1.0	(3.2)	(2.9)	(2.4)	0.9	(1.0)	(0.3)	(1.0)	(1.0)	(1.7)
Gross external financing needs/CARs plus usable reserves	85.3	84.1	86.0	79.1	76.0	70.5	68.5	66.3	65.7	64.9
Narrow net external debt/CARs	(0.9)	(1.3)	(9.5)	(16.5)	(26.8)	(37.1)	(41.7)	(44.3)	(46.6)	(46.6)
Net external liabilities/CARs	(37.2)	(41.9)	(49.1)	(54.4)	(55.4)	(62.2)	(74.6)	(83.3)	(92.1)	(99.9)
Short-term external debt by remaining maturity/CARs	46.2	42.6	45.3	38.5	37.2	37.1	32.7	29.4	28.8	26.9
Reserves/CAPs (months)	8.1	8.0	8.2	8.4	9.0	10.5	10.5	10.7	10.8	10.7
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.9)	(2.0)	(3.7)	(3.1)	(2.6)	(2.4)	(2.9)	(2.9)	(2.9)	(2.9)
Change in debt/GDP	1.1	2.8	3.5	2.9	1.8	1.2	2.1	3.1	3.2	3.1
Primary balance/GDP	1.2	2.1	0.3	0.7	1.1	1.1	0.5	0.4	0.5	0.5
Revenue/GDP	36.9	37.0	35.9	36.8	37.2	36.7	36.7	36.7	36.7	36.7
Expenditures/GDP	39.8	39.0	39.6	40.0	39.8	39.0	39.6	39.6	39.7	39.7
Interest /revenues	11.3	11.0	11.2	10.3	10.0	9.5	9.2	9.1	9.3	9.5
Debt/GDP	70.5	68.7	67.8	67.2	66.7	64.6	64.8	65.0	65.2	65.4
Debt/Revenue	191.3	185.6	189.0	182.3	179.1	176.1	176.5	177.0	177.7	178.3
Net debt/GDP	67.5	65.9	64.9	64.2	64.3	61.8	62.9	63.2	63.5	63.8
Liquid assets/GDP	3.0	2.8	2.9	2.9	2.4	2.8	1.9	1.8	1.7	1.7
MONETARY INDICATORS (%)										
CPI growth	2.7	3.5	1.7	1.5	0.5	(0.6)	(0.2)	0.7	1.4	1.7
GDP deflator growth	1.5	1.8	3.9	2.2	1.0	2.7	0.6	2.1	2.1	2.2
Exchange rate, year-end (LC/$)	3.5	3.8	3.7	3.5	3.9	3.9	3.9	3.9	3.9	3.9
Banks' claims on resident non-gov't sector growth	8.6	7.7	2.6	4.8	4.7	2.4	6.5	6.5	6.0	5.5
Banks' claims on resident non-gov't sector/GDP	80.4	81.0	77.7	77.3	78.1	76.0	78.6	80.0	81.0	81.6
Foreign currency share of claims by banks on residents	7.3	7.4	6.2	4.6	3.9	3.5	4.7	4.7	4.7	4.7
Foreign currency share of residents' bank deposits	24.4	23.7	22.4	22.4	24.3	10.5	10.5	10.5	10.5	10.5
Real effective exchange rate growth	9.9	1.5	(3.1)	6.8	2.1	2.6	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

State of Israel Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Strength
External assessment	Strength
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral
Monetary assessment	Strength

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Default, Transition, and Recovery: 2015 Annual Sovereign Default Study AndRating Transitions, May 24, 2016
- Global Sovereign Rating Trends Mid-Year 2016, July 13, 2016
- Sovereign Risk Indicators, July 6, 2016. An interactive version is also available at http://www.spratings.com/sri.

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the fiscal assessment: debt burden had improved, and all other key rating factors remained unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Israel (State of)		
Sovereign Credit Rating		
Foreign and Local Currency	A+/Stable/A-1	A+/Stable/A-1
Transfer & Convertibility Assessment	AA	AA
Senior Unsecured		
Foreign and Local Currency	A+	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

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