S&P Global Ratings

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Research Update:

Israel Upgraded To 'AA-/A-1+' On Economic Strength And Fiscal Improvements; Outlook Stable

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Research Update:

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Overview

- We expect Israel's economic growth will remain strong, with GDP expanding at a healthy 3.3% over the next four years.
- This, together with general adherence to fiscal rules, will enable the government to lock in recent fiscal gains, with net debt averaging about 57% of GDP through to year-end 2021.
- We are therefore raising our ratings on Israel to 'AA-/A-1+' from 'A+/A-1'.
- The outlook is stable.

Rating Action

On Aug. 3, 2018, S&P Global Ratings raised its long- and short-term foreign and local currency sovereign credit ratings on Israel to 'AA-/A-1+' from 'A+/A-1'. The outlook is stable.

The upgrade reflects improvements in Israel's fiscal policy framework that, alongside exceptionally strong economic performance, have resulted in a pronounced decline in net general government debt over the past eight years. Although public debt remains relatively high, we now think that fiscal slippages leading to a significant reversal of the debt path are unlikely. This is based on our belief that, absent global trade shocks, Israel's economic growth outlook will remain solid and allow the government to accommodate pressures coming from social and infrastructure spending, as well as a potential moderate escalation of security risks. Israel has demonstrated sound economic performance since the global financial crisis, with a current GDP of about $140 billion (or 50%) larger than in 2010, the current account in a sustainable surplus, and unemployment at historical lows.

Outlook

The stable outlook on Israel balances risks coming from elevated security risk against the potential for stronger economic growth prospects, which could support further reduction of public debt. The outlook also factors in our view that Israel's external flow and stock position will remain strong.

We could take a negative rating action if Israel's economic, balance-of-payments, or fiscal performance weakened markedly beyond our forecast, or if domestic or external security risks increased substantially.

A positive rating action could stem from a stronger fiscal consolidation effort resulting in further material reductions in net general government debt or interest payments. We currently see this scenario as unlikely, however.

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 moderate debt burden and, in our view, significant security and geopolitical risks.

Institutional and Economic Profile: A wealthy economy and effective institutions support prudent macroeconomic policies

- Israel enjoys a prosperous, modern, and diversified economy, benefitting from relatively high growth rates.
- Despite fragmented domestic politics, Israeli institutions are strong and accountable.
- High exposure to external and domestic security risks weigh on the country's creditworthiness.

Israel's economy continues to thrive and benefit from diversification, with high-value-added manufacturing and services sectors, especially in the information technology industry. The information and communication sector contributes almost 10% of the gross value added, and scientific and technical activities about 3%. This is underpinned by sizable expenditures on research and development, exceeding 4.5% of GDP on average--the highest among member countries of the Organization for Economic Co-operation and Development.

We assume Israel's economy will expand by about 3.3% on average over 2018-2021. Growth will stem from private consumption on the back of a strong labor market, continued corporate investment activity (not least in the hi-tech sector), and robust performance of services exports, supported by a global economic upswing. In U.S. dollar per capita terms, this equates to somewhat slower growth of 1.4% per year, reflecting continued population growth. We note that the projected growth comes on top of Israel's already vigorous economic performance since the 2008 global financial crisis. For example, GDP in U.S. dollar terms has increased by over 50% compared with that in 2010, and the unemployment rate is at historical lows. With the Leviathan natural gas project coming fully online in the next few years, growth might benefit from an additional boost (not yet reflected in our projections).

In addition, as both the consumer price index and the GDP deflator growth move toward about 2% on average over our forecast horizon, nominal output growth will be notably stronger than real output growth.

Overall, we view institutional and governance structures in Israel to be generally effective. Despite the highly fragmented political situation in the parliament, the ruling coalition successfully passed the budgets for 2017, 2018, and 2019. Moreover, over the past few years, we have observed increased commitment to fiscal prudence, with the government meeting its budgetary objectives, in particular by broadly complying with its fiscal rule.

However, the coalition's diverse composition could constrain the government's capacity to address longer-term structural issues in the economy and society. These issues include excessive red tape, infrastructure gaps, weak labor market participation and poor skills of some social groups (mainly Haredi men and Arab-Israeli women), and housing-related matters. We believe that domestic political volatility--exemplified by recent amendments to the basic laws or proposals to reshape the Supreme Court's powers--will likely stay elevated over the rating horizon.

In addition, Israel is exposed to persistent geopolitical risks. We note continued divergence between the U.S. and other stakeholders (notably the EU) with regards to the peace process with Palestinian authorities, especially after the U.S. moved its embassy to Jerusalem. This might lead to outbreaks of violence in Gaza and surrounding areas, triggering a backlash from the international community. At the same time, we note that geopolitical security risks, although still high, have somewhat moderated. The conflict in Syria, Israel's neighbor on the northern border, has so far had no spillover effect. This could be tied to the weakening of Hezbollah due to its active involvement in the Syrian civil war, which will likely undermine its willingness to challenge Israel in the next few years. Further moderating risks is the U.S. administration's apparent commitment to supporting Israel in case security risks escalate. Nevertheless, any significant armed conflict could adversely affect the ratings on Israel, since it would likely deter investment, weaken economic growth potential, or result in budgetary pressures.

Flexibility and Performance Profile: Lower public debt and strong external finances

- Net public debt will stabilize at below 60% of GDP thanks to contained fiscal deficits, strong GDP growth, and low inflation.
- Solid net external asset position will persist.
- Monetary policy effectiveness is high, with real estate price dynamics posing a key challenge.

Exceptionally favorable macroeconomic conditions have supported Israel's public finance in recent years. The general government's fiscal deficit shrank to about 2.2% of GDP on average in 2015-2017 from an average of 3.3% over 2010-2014, while central government deficits averaged 2.1% and 3.3% for the same periods, respectively. Fiscal results were again strong in 2017, with the deficit at an estimated 2.0% of GDP against the government's target of 2.9%.

Although tax-rich consumption growth, one-time non-tax revenues, and low interest rates have been key factors behind fiscal consolidation, cost-containment measures have also played a role, in our view. Over the past few years, a multi-year spending agreement has been reached with the defense ministry--the source of previous fiscal underperformance. The government has also instituted, and generally complied with, medium-term fiscal rules (i.e. the "numerator" rule), and tightened control over spending commitments for line ministries. These measures, coupled with low inflation (over 50% of Israel's general government debt is linked to the consumer price index), has spurred a decline in public debt by over 10.0% of GDP to 60.8% between 2010 and 2017. Debt remains elevated, however, but its recent downward path stands out prominently relative to its peers.

We now think that the likelihood of material fiscal slippages has decreased. This is because solid economic growth should enable the government to compensate for recent pro-cyclical tax cuts (including on personal and corporate income taxes) and accommodate expenditure pressures from health care and education. We also believe that any new material spending proposals, for example, those related to the recently announced goal of enhancing public infrastructure (i.e. long-term national infrastructure strategy), will unlikely compromise fiscal stability. This is mainly thanks to the state's demonstrated commitment to, and the existing political consensus on, containing public debt.

Accordingly, we expect general government deficits of GDP to stay at 2.8% or slightly below on average. At the same time, net general government debt--that is, gross debt net of liquid government assets (mainly in the form of deposits at the Bank of Israel [BOI; the central bank])--will likely stabilize at a moderate 57% of GDP on average in 2018-2021.

Strong export performance--especially booming high-value-added services exports--and the ongoing development of Israel's offshore natural gas fields, with its significant export capacity, support the country's strong external profile. This will enhance Israel's position as a net creditor versus the rest of the world, with liquid external assets exceeding gross external debt by over 50% of current account payments over our entire forecast horizon. These dynamics also contain the country's gross external financing needs (payments to nonresidents), indicating low dependence on external financing.

In addition, we consider Israel's monetary policy flexibility to be a credit strength. BOI has been intervening in foreign exchange markets, over and above its commitment to purchase foreign currency 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 our view.

Additionally, the BOI is sticking to accommodative monetary policy, countering the strength of the shekel to maintain the competitiveness of Israel's exports. It has maintained the historical low of 0.1% as its key policy rate since March 2015. Yet, since then, the shekel has continued to appreciate against the currencies of key trading partners, owing to Israel's strong fundamentals, namely its current account surpluses, strong net foreign direct investment, and high GDP growth rates. Currency appreciation was one of the factors for negative consumer price inflation in 2015-2016 and only modestly positive inflation in 2017. Despite the weakening of the shekel against the U.S. dollar in the first half of 2018 (driven by higher rates in the U.S.), we expect moderate currency appreciation to resume going forward. In our opinion, this will continue posing pricing risk, adding to the need for continued innovation and reduction of regulatory pressures for local businesses to remain competitive in external markets.

One of the key challenges to monetary policy continues to be rising house prices. Real house prices have increased by over 100% since the end of 2007. The BOI's past attempts to dampen the housing market by raising interest rates delivered limited results and pushed up the foreign exchange rate. Thereafter, the BOI shifted focus to a series of macroprudential measures targeted at the mortgage market. More recently, the government has implemented comprehensive measures to cut speculative demand and increase the housing supply, including freeing up more land for development, changing the tendering criteria, allowing foreign presence in the construction market, and accelerating processes for construction permissions. Given capacity constraints, relatively low productivity in the construction industry, and continued growth in demand, addressing the supply shortage might take time, however.

Israeli banks' exposure to the local real estate sector, mainly to residential mortgage loans, has increased in recent years. The banking system's exposure to loans for construction, commercial real estate, and mortgages now accounts for about 45% of total bank loans compared with 32% 10 years ago. Even though the tightening of macroprudential measures has reduced systemic risks to Israel's banking industry, and the housing market seems to have cooled in 2017 (real housing price growth slowed down to just 2.4% from an average of 6% in 2012-2016), any abrupt correction in house prices could still weigh on the economy (see "Banking Industry Country Risk Assessment: Israel," published Oct. 30, 2017, on RatingsDirect).

Key Statistics

Table 1

Israel Selected Indicators										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ILS)	992	1,056	1,103	1,163	1,220	1,263	1,328	1,402	1,478	1,559
Nominal GDP (bil. $)	257	292	308	299	318	351	376	401	435	459
GDP per capita (000s $)	32.5	36.3	37.5	35.7	37.2	40.2	42.3	44.3	47.1	48.8
Real GDP growth	2.2	4.2	3.5	2.6	4.0	3.3	3.6	3.3	3.2	3.1
Real GDP per capita growth	0.3	2.3	1.5	0.6	1.9	1.3	1.6	1.4	1.2	1.2

Table 1

Israel Selected Indicators (cont.)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real investment growth	4.2	3.8	0.7	(0.8)	11.9	2.8	4.3	3.0	3.2	3.2
Investment/GDP	21.2	20.0	20.2	19.8	20.5	20.8	20.5	21.0	21.1	21.3
Savings/GDP	21.8	22.9	24.0	24.9	24.2	23.7	23.5	24.0	24.0	24.1
Exports/GDP	36.1	33.3	32.2	31.3	30.3	29.2	29.1	28.8	28.7	28.4
Real exports growth	(2.0)	3.3	1.9	(2.7)	2.5	3.6	3.3	3.1	3.2	3.0
Unemployment rate	6.9	6.3	6.0	5.3	4.8	4.2	4.2	4.0	4.0	4.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.6	2.9	3.8	5.1	3.7	3.0	3.0	3.0	2.9	2.8
Current account balance/CARs	1.3	7.4	9.8	13.3	10.0	8.3	8.4	8.5	8.4	8.3
CARs/GDP	42.9	39.8	39.3	38.8	37.3	35.6	35.5	35.1	34.4	34.2
Trade balance/GDP	(3.6)	(2.7)	(2.3)	(1.1)	(2.3)	(2.7)	(2.7)	(2.8)	(2.7)	(2.7)
Net FDI/GDP	2.6	2.7	0.5	0.1	(0.4)	3.6	1.3	1.0	1.0	1.0
Net portfolio equity inflow/GDP	(2.8)	(2.4)	0.9	(1.1)	0.1	0.4	(1.0)	(1.1)	(1.0)	(0.9)
Gross external financing needs/CARs plus usable reserves	86.3	79.9	76.4	70.5	68.7	69.4	65.4	63.5	62.8	61.8
Narrow net external debt/CARs	(8.6)	(15.6)	(24.7)	(35.0)	(38.9)	(53.9)	(53.0)	(55.1)	(56.9)	(59.2)
Narrow net external debt/CAPs	(8.7)	(16.8)	(27.4)	(40.4)	(43.2)	(58.8)	(57.9)	(60.2)	(62.1)	(64.5)
Net external liabilities/CARs	(50.2)	(56.2)	(55.8)	(58.9)	(89.5)	(114.0)	(113.1)	(112.3)	(110.8)	(110.4)
Net external liabilities/CAPs	(50.9)	(60.6)	(61.9)	(67.9)	(99.4)	(124.4)	(123.4)	(122.8)	(120.9)	(120.4)
Short-term external debt by remaining maturity/CARs	46.3	39.4	37.8	36.1	31.3	30.8	29.2	26.1	24.5	23.3
Usable reserves/CAPs (months)	8.3	8.5	9.0	10.3	10.2	10.0	11.1	11.2	11.1	11.3
Usable reserves (mil. $)	75,908	81,786	86,101	90,575	95,446	113,010	119,778	126,989	134,816	143,070
FISCAL INDICATORS (%, General government)										
Balance/GDP	(4.1)	(3.8)	(2.9)	(2.1)	(2.3)	(2.2)	(2.8)	(2.8)	(2.8)	(2.8)
Change in net debt/GDP	3.3	2.7	2.3	0.7	1.1	0.4	2.5	2.5	2.5	2.5
Primary balance/GDP	(0.1)	(0.0)	0.8	1.3	0.9	0.9	0.2	0.2	0.2	0.2
Revenue/GDP	35.8	36.2	36.5	36.7	36.4	37.8	37.6	37.6	37.6	37.6
Expenditures/GDP	39.9	40.1	39.4	38.9	38.8	40.0	40.4	40.4	40.4	40.4
Interest /revenues	11.3	10.5	10.1	9.4	8.8	8.2	7.9	7.9	8.0	7.9
Debt/GDP	68.4	67.1	66.1	64.0	62.3	60.8	60.3	59.6	59.0	58.5
Debt/Revenue	191.3	185.2	180.9	174.3	171.0	160.9	160.3	158.5	157.0	155.5
Net debt/GDP	65.5	64.2	63.8	61.3	59.4	57.9	57.4	56.9	56.5	56.1
Liquid assets/GDP	2.9	2.9	2.3	2.8	2.8	3.0	2.8	2.7	2.5	2.4
MONETARY INDICATORS (%)										
CPI growth	1.7	1.5	0.5	(0.6)	(0.5)	0.2	1.0	1.5	1.8	1.8

Table 1

Israel Selected Indicators (cont.)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
GDP deflator growth	3.7	2.2	1.0	2.7	1.0	0.2	1.6	2.2	2.2	2.3
Exchange rate, year-end (ILS/$)	3.73	3.47	3.89	3.90	3.85	3.47	3.60	3.40	3.40	3.40
Banks' claims on resident non-gov't sector growth	2.6	4.8	4.8	2.4	3.0	4.1	5.0	5.5	5.5	5.5
Banks' claims on resident non-gov't sector/GDP	78.4	77.2	77.4	75.2	73.8	74.2	74.1	74.0	74.1	74.1
Foreign currency share of claims by banks on residents	6.2	4.6	3.9	3.5	3.1	2.7	2.7	2.8	2.8	2.9
Foreign currency share of residents' bank deposits	22.4	22.4	24.3	10.5	11.3	10.5	10.5	10.5	10.5	10.5
Real effective exchange rate growth	(2.8)	6.3	2.3	2.9	2.9	8.2	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. ILS--Israeli shekel. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. M/A--Not applicable. 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

Ratings Score Snapshot

Key rating factors	
Institutional assessment	4
Economic assessment	1
External assessment	1
Fiscal assessment: flexibility and performance	3
Fiscal assessment: debt burden	3
Monetary assessment	2

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). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score 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 scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings Score Snapshot, Aug. 2, 2018
- Global Sovereign Rating Trends Midyear 2018, July 16, 2018
- Sovereign Risk Indicators, July 5, 2018. A free interactive version is available at http://www.spratings.com/sri
- Sovereign Ratings List, July 5, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Why Are Sovereign Foreign And Local Currency Ratings Converging?, Jan. 10, 2018
- Banking Industry Country Risk Assessment: Israel, Oct. 30, 2017

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's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

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

Upgraded

	To	From
Israel		
Sovereign Credit Rating	AA-/Stable/A-1+	A+/Positive/A-1
Senior Unsecured	AA-	A+
Transfer & Convertibility Assessment	AA+	AA

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