S&P Global
Ratings

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Research Update:

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

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Overview

- We forecast Israel's economy to contract by 5.0% in 2020 because of the pandemic, before recovering by 4.5% next year.
- The pandemic will drive a notable deterioration in public finances with net general government debt stabilizing at 77% of GDP over the medium term, up almost 20 percentage points from 59% at the end of 2019.
- Nevertheless, we view Israel's debt structure as favorable, with the lion's share of debt denominated in local currency and held by residents. The country also benefits from a credible and effective monetary policy and a strong balance of payments.
- We are therefore affirming our 'AA-/A-1+' sovereign ratings on Israel.
- The outlook is stable.

Rating Action

On Nov. 13, 2020, S&P Global Ratings affirmed its 'AA-/A-1+' long- and short-term foreign and local currency sovereign credit ratings on Israel. The outlook is stable.

Outlook

The stable outlook on Israel balances pandemic-related risks over the next 18-24 months against the country's resilient economy and strong balance of payments position. We project that Israel's net external asset position will remain about 45% of GDP through 2023, providing the economy with substantial buffers in the face of a fraught external environment.

We could take a negative rating action if the economic downturn proved deeper and longer than expected, leading to a more substantial deterioration of public finances than we currently forecast. Pressure on the ratings could also build if, beyond immediate pandemic-related effects, Israel lacked a medium-term fiscal consolidation plan and net general government debt kept rising--as opposed to our current forecast that it will stabilize at under 80% of GDP. This could happen, for instance, if domestic political uncertainty and a fragmented government made it difficult to agree fiscal priorities.

A positive rating action could stem from fiscal outturns being materially stronger than our current projections or a major improvement in the Middle East's security environment.

Rationale

The rating affirmation primarily reflects Israel's credit strengths. These include its wealthy and resilient economy, its net external creditor position, and the benefits that accrue to the state from flexible monetary settings and a relatively deep pool of domestic savings. In our view, these characteristics should help cushion the deterioration in its fiscal performance amid the pandemic.

We forecast Israel's net general government debt to this year rise by almost 15 percentage points from under 59% of GDP at the end of 2019 to 73% at end-2020. We expect it will stabilize at close to 77% over the medium term. Although this represents a notable deterioration in the fiscal outlook compared with our pre-pandemic projections, Israel will still have some fiscal headroom. In addition to the credible and effective monetary policy that has supported the economy and kept borrowing costs low, we expect the country to retain a highly favorable general government debt structure. Close to 85% of government debt is denominated in the local currency, the Israeli new shekel, and is held domestically by local banks and institutional investors, such as pension funds.

Our ratings on Israel remain constrained by significant security and geopolitical risks.

Institutional and economic profile: Israel's first recession in decades will be followed by a partial recovery in 2021

- We expect Israel's economy to contract by 5.0% in 2020 before recovering by 4.5% in 2021.
- Domestic political uncertainty lingers and the country could go to elections for the fourth time in two years.
- The landmark Abraham Accords signed recently between Israel, Bahrain, and the UAE should underpin closer cooperation between the three, but broader regional geopolitical risks remain elevated.

Throughout 2020, Israel has felt the effects of the pandemic. Earlier this year, the authorities promptly introduced containment measures, some as early as January-February before a full lockdown from mid-March until the end of April. However, as the government gradually eased measures cases started to spike again during the summer before a second lockdown in September. This has also been gradually eased.

In parallel, the authorities have unveiled a number of support programs to shield the economy, which are broadly similar to those adopted by other countries, particularly in Western Europe. The overall measures announced to date are worth around 10% of GDP and include:

- Additional allocations for direct health and civilian response;
- Support for businesses via grants, a government loan guarantee program, cancellation of property taxes, refunds of advance tax payments, and postponement of VAT, utilities, and government permit payments;
- Support for salaried workers and self-employed small business owners.

Although the government support measures should soften the impact of the pandemic on the domestic economy, we expect Israel will register a large output contraction in 2020. High-frequency data--credit card spending, the industrial production index, and the index of retail trade revenue--indicate a quick economic rebound from the first lockdown. However, prospects dipped once more when restrictions were reintroduced in September. It is difficult to quantify the impact of the second lockdown, but we assume it will be similar to the first.

Our baseline forecast for 2020 is, for now, largely unchanged: we expect the economy will contract by 5% this year. Although we did not previously think Israel would go into a second lockdown, the effects on economic growth could be counterbalanced by a stronger apparent performance over the third quarter following the easing of the first round of restrictions. Nevertheless, for full-year 2020, we expect all key GDP components will shrink including private domestic consumption, exports, and investments. National accounts data for first-half 2020 show imports contracting much quicker than exports, which could reflect the depth of pandemic-related effects on domestic demand.

Our economic forecasts for Israel remain subject to high uncertainty and ultimately depend on how the virus plays out domestically, as well as on the performance of Israel's key trade partners. Following a contraction in 2020, we forecast that the economy will recover partially by 4.5% in 2021. This is lower than our May projection (6.5%) and does not represent a particularly steep recovery, especially if population growth (which has historically averaged 2% annually) is taken into account. Ongoing risks and uncertainties include potential further lockdowns if virus cases increase again, the economic performance of key trade partners, and the timeframe for a vaccine becoming widely available.

It is also still difficult to estimate any permanent damage to the economy from the pandemic. Positively, the technology sector retains a key role for the Israeli economy and has expanded strongly in recent years. It might be better placed than some sectors to withstand the pandemic given employees' comparatively higher ability to work from home if needed, and the likely increased demand for technological services outside Israel even if traditional export channels contract. Beyond the tech sector, however, the pandemic could drive some Israeli companies out of business permanently.

Domestic political uncertainty and volatility remains high. The country has gone through three inconclusive elections over the past 18 months. At the end of April, incumbent prime minister, Benjamin Netanyahu, and the leader of center-right Blue and White Party, Benny Gantz, signed an agreement to form a unity coalition government under which they would take turns (18 months each) in the prime ministerial role. The High Court of Justice cleared the way for Mr. Netanyahu to form the government despite ongoing criminal proceedings against him.

Despite the coalition formation, Israel has yet to adopt a state budget for 2020 after the previous August deadline was delayed, at the last minute, until the end of December. Fragmentation within the government also appears high with leaders reportedly holding talks with opposition parties, possibly positioning for yet another election in the coming months. Positively--and despite this continued brinkmanship and the lack of a conventional budget--the Knesset has been able to approve large fiscal stimulus measures to support the economy. Also, historically, the inherent political volatility has not meaningfully affected the economy; we saw this in the strong 3.5% growth rate in 2018-2019. We view this as a testament to the country's comparatively strong institutional settings.

One factor that differentiates Israel from other advanced economies is its exposure to persistent geopolitical and domestic security risks. On top of longstanding historical factors, more recently these stem from the continued divergence between the U.S. and other stakeholders (notably the EU) regarding the peace process with the Palestinian authorities. This is especially after the U.S.

moved its embassy to Jerusalem and recognized Israeli sovereignty over the Golan Heights. These developments have led to repeated outbreaks of violence throughout Gaza and the West Bank, and triggered a backlash from parts of the international community. In addition, escalating tensions between the U.S. and Iran could heighten the risk of open military conflict, involving Israel, Iran, and Iran-supported Hezbollah, as well as other militant groups operating in Lebanon and Syria. Past episodes of geopolitical turbulence have had an adverse effect on Israel's economic and fiscal performance.

Positively, we consider that the recently signed Abraham Accords between Israel, the UAE, and Bahrain should contribute to economic, trade, and security cooperation between the three.

Flexibility and performance profile: The fallout from the pandemic will push public debt up by almost 20 percentage points of GDP

- Automatic stabilizers and direct fiscal stimulus will widen the government deficit to 12% of GDP and push net general government debt to 73% in 2020.
- Strong capital market access and the Bank of Israel's (BOI) bond purchasing program will support government financing efforts.
- Monetary policy credibility remains high, despite expected price deflation in 2020.

The recession has exposed the government's weak underlying fiscal position, which has resulted from procyclical tax and expenditure measures over the past three years. Direct fiscal measures (which we estimate at about 5% of GDP, excluding state guarantees) and the impact of the economic downturn on both fiscal revenue and expenditure will widen the general government deficit to 12% of GDP in 2020 compared with the already elevated average of 4.4% in 2018-2019.

Such a substantial deterioration in the government fiscal balance will lead to an increase in net general government debt (gross debt net of liquid government assets) to an elevated 73% of GDP by end-2020. This will reverse the reduction of public debt to GDP, achieved over the past 10 years thanks to exceptionally favorable macroeconomic conditions, one-off fiscal revenue, and exchange-rate appreciation.

However, we think fiscal stability should broadly prevail in Israel because:

- Unlike many regional peers, it benefits from highly flexible monetary policy settings, which will allow the BOI to backstop a substantial portion of gross government borrowing requirements, keeping its market borrowing costs under control. The BOI's government bond purchasing program (introduced earlier this year and expanded in October) could backstop Israel's additional borrowing requirements without any sizable inflation or exchange rate risks.
- Israel benefits from strong access to capital markets, both domestically and internationally. This has supported the government's efforts to diversify its funding base and lengthen the average debt maturity. Although the government traditionally funds itself in the deep domestic capital markets, we also note recent international bond issuances with maturities extending from 30 to 100 years. It could tap foreign markets again in light of substantial investor demand. In the unlikely event of funding disruptions, the government could also still use the remaining portion of a longstanding U.S. debt guarantee program.
- The existing budget revenue and spending composition offers space to rationalize tax benefits, increase rates for some taxes, and improve tax compliance and administration. It also provides scope for spending efficiency gains over the medium term beyond the pandemic's impact.

Although downside risks remain--especially if the recovery of nominal GDP growth is slower than we anticipate--our base case is that the government will initiate efforts to consolidate fiscal accounts starting from the second half of 2021. Under this scenario, headline general government deficits would go down to 4% in 2022-2023 with public debt stabilizing at close to 77% of GDP.

We consider Israel's balance of payments a key ratings strength. The country has been running a current account surplus for the past 17 years, primarily supported by the fast expansion of high-value-added ICT services exports (the total external services surplus has averaged 5% of GDP in the past few years). This has shifted Israel into a substantial net external asset position of about 40% of GDP, one of the highest among non-commodity-exporting sovereigns, and reduced its gross external financing needs. Despite the sharp drop in exports in 2020, we expect the external balance to remain in surplus as shrinking domestic demand will reduce imports. Recovering global demand for Israeli services, as well as the development of offshore natural gas fields with significant export capacity, should keep the current account surplus at its pre-pandemic level of around 3% of GDP over the medium term.

We also consider Israel's monetary policy flexibility a key credit strength. The BOI is a highly credible institution, with a long track record of operational independence and a full suite of market-based monetary instruments, benefiting from the deep local currency financial and capital markets. This year, the bank has deployed its arsenal of available tools to soften the effects of the pandemic on the Israeli economy through policy rate cuts, quantitative easing, low interest rate loans to banks, and others. Meanwhile, the bank has also amassed substantial foreign exchange reserves of close to US$160 billion as of end-October (around 40% of GDP). We note that current foreign exchange reserve levels cover Israel's overall external debt 1.7x.

The Israeli banking system is well capitalized, profitable, and liquid. Banks' asset quality has been historically high--nonperforming loans stood at just 1.3% of total loans in 2019. The system is domestic-deposit funded and remains in a net external asset position. Although banks will inevitably suffer from weaker economic activity and the crisis-driven loan repayment moratorium, substantial capital and liquidity buffers, in tandem with regulatory and liquidity support, should enable them to mitigate the ongoing macroeconomic shock.

Key Statistics

Table 1

Israel Selected Indicators

Mil. ILS	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. LC)	1,109	1,167	1,224	1,269	1,330	1,407	1,347	1,415	1,488	1,563
Nominal GDP (bil. $)	310	300	319	353	370	395	389	416	441	470
GDP per capita (000s $)	37.8	35.8	37.3	40.5	41.7	43.6	42.2	44.3	46.0	48.2
Real GDP growth	3.9	2.2	3.8	3.6	3.5	3.4	(5.0)	4.5	3.5	3.5
Real GDP per capita growth	2.0	0.2	1.8	1.6	1.5	1.5	(6.8)	2.6	1.6	1.6
Real investment growth	1.0	(1.0)	12.7	4.6	5.1	2.5	(6.0)	3.0	3.5	3.5
Investment/GDP	20.6	19.9	21.1	21.5	21.7	21.4	21.5	21.2	21.1	21.0

Table 1

Israel Selected Indicators (cont.)

Mil. ILS	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Savings/GDP	24.4	25.3	24.8	24.4	24.4	24.8	25.1	24.6	24.2	23.8
Exports/GDP	32.3	31.5	30.0	28.8	29.8	29.3	27.9	27.8	27.4	27.0
Real exports growth	0.8	(2.4)	0.8	3.5	6.4	4.0	(6.0)	3.5	3.0	3.0
Unemployment rate	5.9	5.3	4.8	4.3	4.0	3.8	4.7	6.0	5.0	4.5
External indicators (%)										
Current account balance/GDP	3.9	5.4	3.7	2.9	2.7	3.4	3.6	3.4	3.1	2.8
Current account balance/CARs	9.8	13.7	9.9	8.1	7.2	9.4	10.4	9.8	9.1	8.2
CARs/GDP	39.1	39.2	37.5	35.9	37.0	36.1	34.6	34.7	34.2	33.7
Trade balance/GDP	(2.3)	(1.1)	(2.5)	(3.0)	(4.7)	(4.0)	(3.2)	(3.6)	(3.7)	(3.8)
Net FDI/GDP	0.5	0.1	(0.8)	2.6	4.2	2.6	3.5	3.0	3.0	3.0
Net portfolio equity inflow/GDP	0.2	1.0	1.4	0.0	(4.2)	(1.5)	(2.0)	(2.5)	(2.5)	(2.5)
Gross external financing needs/CARs plus usable reserves	76.4	70.3	68.9	68.8	66.3	64.9	62.0	57.2	57.5	57.6
Narrow net external debt/CARs	(24.6)	(34.6)	(41.2)	(54.1)	(46.6)	(51.7)	(66.4)	(62.1)	(62.3)	(62.3)
Narrow net external debt/CAPs	(27.3)	(40.1)	(45.7)	(58.9)	(50.3)	(57.1)	(74.1)	(68.8)	(68.6)	(67.9)
Net external liabilities/CARs	(55.8)	(58.2)	(88.4)	(111.5)	(97.4)	(113.5)	(133.2)	(131.7)	(133.4)	(134.5)
Net external liabilities/CAPs	(61.8)	(67.4)	(98.0)	(121.4)	(105.1)	(125.3)	(148.7)	(146.1)	(146.7)	(146.5)
Short-term external debt by remaining maturity/CARs	37.7	35.6	31.1	30.4	28.3	26.9	30.4	27.8	27.5	26.4
Usable reserves/CAPs (months)	9.0	10.2	10.1	10.1	10.7	10.7	12.5	14.1	14.0	13.7
Usable reserves (mil. $)	86,105	90,623	98,361	113,010	115,279	126,023	153,268	159,509	166,122	173,175
Fiscal indicators (general government; %)										
Balance/GDP	(2.5)	(1.4)	(1.9)	(2.1)	(4.3)	(4.5)	(12.0)	(7.5)	(4.2)	(4.0)
Change in net debt/GDP	2.3	0.7	1.1	0.5	3.1	3.0	11.9	7.5	4.0	3.8
Primary balance/GDP	1.2	2.0	1.3	1.0	(1.4)	(1.7)	(8.9)	(4.2)	(0.7)	(0.5)
Revenue/GDP	36.5	36.8	36.3	37.5	35.9	35.2	34.0	35.0	36.0	36.0
Expenditures/GDP	39.0	38.2	38.2	39.6	40.2	39.7	46.0	42.5	40.2	40.0
Interest/revenues	10.1	9.3	8.8	8.2	8.2	8.1	9.0	9.5	9.7	9.8

Table 1

Israel Selected Indicators (cont.)

Mil. ILS	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Debt/GDP	65.7	63.8	62.1	60.6	60.9	60.0	74.5	78.4	78.6	78.7
Debt/revenues	180.3	173.6	171.0	161.6	169.7	170.4	219.1	224.1	218.4	218.5
Net debt/GDP	64.2	61.8	60.0	58.4	58.8	58.6	73.0	77.0	77.3	77.4
Liquid assets/GDP	1.5	2.0	2.1	2.3	2.1	1.4	1.5	1.4	1.3	1.3
Monetary indicators (%)										
CPI growth	0.5	(0.6)	(0.5)	0.2	0.8	0.8	(0.6)	0.5	1.5	1.5
GDP deflator growth	1.0	2.8	1.0	0.2	1.3	2.2	0.8	0.5	1.6	1.5
Exchange rate, year-end (LC/$)	3.89	3.90	3.85	3.47	3.75	3.46	3.40	3.40	3.35	3.30
Banks' claims on resident non-gov't sector growth	3.5	5.9	3.9	4.0	6.2	4.8	2.0	3.5	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	70.3	70.8	70.1	70.3	71.3	70.7	75.3	74.2	74.1	74.0
Foreign currency share of claims by banks on residents	6.2	5.4	4.9	4.3	4.2	3.7	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	19.6	19.2	19.2	18.0	18.5	18.5	N/A	N/A	N/A	N/A
Real effective exchange rate growth	0.6	0.6	3.4	7.9	(0.9)	2.1	N/A	N/A	N/A	N/A

Sources: The Bank of Israel, Israel Central Bureau of Statistics, International Monetary Fund (Economic Indicators), Israel Central Bureau of Statistics, The Bank of Israel (External Indicators), Bank of Israel and Ministry of Finance of the Government of Israel (Fiscal Indicators), and the Bank of Israel, International Monetary Fund (Monetary Indicators).
Adjustments: None.
Definitions: 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 claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. 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

Israel Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	4	Generally effective policymaking promoting sustainable public finance and balanced economic growth, but less cohesive civil society because of ethnic and religious tensions.

Table 2

Israel Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
		External security risks, including risks of war stemming from domestic conflicts (Palestine and Gaza) and from strained relations with some neighboring countries.
Economic assessment	1	Based on GDP per capita ($) as per the Selected Indicators table above.
External assessment	1	Based on narrow net external debt and gross external financing needs as per the Selected Indicators table above.
Fiscal assessment: flexibility and performance	3	Based on the change in net general government debt (% of GDP) as per Selected Indicators table above, adjusted for the one-off impact of COVID-19 pandemic.
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators table above.
Monetary assessment	2	Managed-float exchange-rate regime. The central bank has a track record of operational independence and it uses market-based monetary instruments and has the ability to act as a lender of last resort. CPI as per Selected Indicators table above; the local currency financial and capital markets are deep.
Indicative rating	aa	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	-1	Event risk related to potential cases of rapidly rising external political crises, such as a large-scale ground war with Iran and multiple scenarios of terrorism.
Final rating		
Foreign currency	AA-	
Notches of uplift	0	Default risks do not apply differently to foreign-and local-currency debt.
Local currency	AA-	

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 Dec. 18, 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Oct. 14, 2020
- Sovereign Ratings History, Oct. 14, 2020
- Sovereign Risk Indicators, Oct. 12, 2020. An interactive version is available at www.spglobal.com/sri
- Default, Transition, And Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020

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

Ratings Affirmed	
Israel	
Sovereign Credit Rating	AA-/Stable/A-1+
Transfer & Convertibility Assessment	AA+
Senior Unsecured	AA-