Research Update:

Israel Long-Term Ratings Lowered To 'A+' From 'AA-' On Heightened Geopolitical Risk; Outlook Negative

April 18, 2024

Overview

- In our view, the recent increase in confrontation with Iran heightens already elevated geopolitical risks for Israel. We expect a wider regional conflict will be avoided, but the Israel-Hamas war and the confrontation with Hezbollah appear set to continue throughout 2024--versus our previous assumption of military activity not lasting more than six months.
- We forecast that Israel's general government deficit will widen to 8% of GDP in 2024, mostly as a result of increased defense spending. Higher deficits will also persist over the medium term, and we expect net general government debt to peak at 66% of GDP in 2026.
- A wider regional conflict, which is not our baseline scenario, could have a further material negative impact on Israel's security situation and, consequently, its economic, fiscal, and balance-of-payments parameters.
- We lowered our sovereign credit ratings on Israel to 'A+/A-1' from 'AA-/A-1+'. The outlook on the long-term ratings is negative.

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Rating Action

On April 18, 2024, S&P Global Ratings lowered its long-term foreign and local currency sovereign credit ratings on Israel to 'A+' from 'AA-' and the short-term ratings to 'A-1' from 'A-1+'. The outlook on the long-term ratings is negative. We also revised the transfer and convertibility assessment to 'AA' from 'AA+'.

As sovereign ratings (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on Israel are subject to certain publication restrictions set out in article 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2024 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 20, 2023). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation is the significant increase of geopolitical and security risks around Israel. The next scheduled ratings review for Israel is on May 10, 2024.

Outlook

The negative outlook reflects the risk that the Israel-Hamas war and the confrontation with Hezbollah could escalate or affect Israel's economic, fiscal, and balance-of-payments parameters more significantly than we currently expect.

Downside scenario

We could lower the ratings on Israel if the ongoing conflicts widen, further increasing the security and geopolitical risks that Israel faces. We could also lower the ratings in the next 12-24 months if the impact of the conflicts on Israel's economic growth, fiscal position, and balance of payments proves more significant than we currently project.

Upside scenario

We could revise the outlook to stable if we viewed the likelihood of military escalation as reduced and the broader security risks moderated.

Rationale

The downgrade follows what we view as a further increase in already high geopolitical risks that Israel faces in the aftermath of the first direct attack by Iran in mid-April 2024. This attack followed Israel's reported strike on Iran's consulate in Damascus. Under our baseline scenario, we still expect a wider regional conflict will be avoided, but the Israel-Hamas war and the confrontation with Hezbollah appear set to continue throughout 2024. This is in contrast to our October 2023 expectation of military activity not lasting more than six months.

We currently see several possible military escalation risks, including a more substantial, direct, and sustained military confrontation with Iran. Israel faces international pressure to contain its response to the April 13 attack, while Iran has communicated its intention not to escalate. Nevertheless, risks of accidents or miscalculation remain, in our view, particularly if there was further exchange of fire by the two sides.

Another scenario involves a widening of the conflict with Hezbollah at Israel's northern border. This could be the case, for example, if Hezbollah's attacks intensify or Israel decides to implement a military intervention in Lebanon to establish a safety zone and move Hezbollah further away from the border on Lebanon's side.

A widening of the current conflicts could present additional security and social risks for Israel, hurting a variety of economic and fiscal metrics, in contrast to our baseline scenario. Such scenarios remain difficult to reliably quantify.

Our updated baseline forecast for Israel is now based on the following assumptions:

- The Israel-Hamas war continues, likely with easing intensity, throughout 2024.
- A regular exchange of fire persists with Hezbollah at Israel's northern border, but this does not escalate into a more direct war.
- The conflict does not widen across the Middle East. We assume there will be no substantial continuing direct confrontation with Iran and no broader instability in the West Bank.

Under the above assumptions, we expect real growth to be 0.5% in 2024, following 2% growth in 2023. In fourth-quarter 2023, Israel's GDP contracted by 5.7% on a quarterly basis. Given the past resilience and arguably higher capacity of the Israeli economy to adapt to the impact of military conflicts, we expect a significant rebound in growth in the first quarter of 2024.

Nevertheless, quarterly output will remain below prewar levels throughout 2024 given the continuing disruption and high uncertainty. By expenditure, investment has registered the steepest fall of 26% in the final quarter of 2023, and we expect it will take the longest to recover the previous peak. In contrast, we expect consumption spending (combined public and private) already recovered in the first quarter of 2024.

By sector, we see several constraints that are likely to linger throughout the year. Construction and agricultural sectors, which constitute 5% of GDP and 1% of GDP, respectively, previously relied significantly on Palestinian workers, which have been absent since commuting from Gaza and the West Bank has been severely restricted. The government has already taken a number of measures to fill the gap with foreign workers, but such a solution is unlikely to fully materialize in the near future.

The foreign tourism sector has been significantly affected as well, with overseas arrivals sharply falling since October 2023. We expect this trend to persist even if the security situation improves because it will likely take time for confidence to fully return afterward.

We expect that as military activity gradually subsides by the end of this year, growth will rebound more firmly in 2025 by 5% as pent-up consumption and investments take place. That said, it remains uncertain whether there could be longer-term scarring for the Israeli economy--for example, as a result of foreign investors reassessing the risk premiums, resulting in lower direct investment flows. We currently project growth rates of 3.5% on average over 2026-2027.

We expect the general government deficit will widen substantially to 8% of GDP this year from 6.7% of GDP last year and 1.8% of GDP in 2022. The main reasons for the widening are additional defense spending and the adverse impact on revenue from lower economic growth and extra civilian expenditures to compensate for economic and physical damage from the ongoing conflicts.

Our forecasts incorporate the continuing financial support to Israel from the U.S. However, this could be put into question if disagreements between the two countries on developments in Gaza persist, given the U.S.'s publicly stated concerns about the mounting civilian toll of the conflict in Gaza.

We also expect wider budget deficits to persist over the medium term because the defense spending will likely be higher in light of elevated security risks. Positively, Israel has already taken some measures to contain the longer-term fiscal impact, in particular through a hike in the value-added tax rate from 2025.

Under these expectations, we forecast the net general government debt will peak at 66% of GDP in 2026, before stabilizing and declining gradually thereafter. This contrasts with our prewar projection of debt at 54% of GDP in 2026.

Israel's structure of debt remains very favorable. As of year-end 2023, 84% of government debt was held domestically and denominated in local currency. This, in turn, limits the confidence risks and potential for nonresident capital flight. Short-term debt constitutes close to 8% of total while the average time to maturity is nine years.

Israel also recently demonstrated continued access to the international capital market with an US$8 billion bond issuance across different maturities (five, 10, and 30 years) in early March 2024. This was the first public international issuance since October 2023, and although the cost has increased, the issuance was several times oversubscribed.

We expect Israel's balance of payments will remain a key ratings strength. The country has been running a current account surplus for decades, primarily supported by the fast expansion of high-value-added information and communication technology services exports. The total external services surplus has averaged 7% of GDP in the past few years. As a result, Israel has shifted into a substantial net external asset position of about 30% of GDP--one of the highest among non-commodity-exporting sovereigns--and reduced its gross external financing needs.

In 2023, the current account surplus amounted to 5% of GDP, up from 4% of GDP on average over 2020-2022. Although the war has significantly affected the foreign tourism sector, it constitutes just 3% of Israeli current account receipts, while outbound tourism has also notably declined. We expect the exports of high-value-added technology goods and services will continue uninterrupted and Israel's current account surpluses will average 3.6% of GDP through 2027.

Following a dip in October 2023, the Bank of Israel's gross international reserves have recovered to above prewar levels, reaching US$214 billion (42% of GDP) at the end of March 2024. This is a significant buffer, in our view, given that it covers by 1.5x the gross external debt of the whole economy (including the public sector, banks, and the nonbank corporate sector) and affords Israel policy room to maneuver.

Key Statistics

Table 1

Israel--Selected indicators

	2018	2019	2020	2021	2022	2023	2024f	2025f	2026f	2027f
Economic indicators (%)										
Nominal GDP (bil. LC)	1,347	1,425	1,417	1,582	1,764	1,868	1,915	2,051	2,170	2,300
Nominal GDP (bil. $)	375	400	412	490	525	509	516	540	579	622
GDP per capita (000s $)	42.2	44.2	44.7	52.3	55.0	52.3	51.9	53.3	56.0	58.9
Real GDP growth	4.1	3.8	(1.5)	9.3	6.5	2.0	0.5	5.0	3.5	3.5
Real GDP per capita growth	2.1	1.8	(3.2)	7.5	4.5	0.0	(1.5)	2.9	1.5	1.5
Real investment growth	7.6	3.9	(3.1)	13.6	10.4	(4.6)	(6.0)	11.0	5.0	4.0
Investment/GDP	23.9	23.7	24.2	25.3	26.9	25.7	24.4	25.8	25.9	25.8
Savings/GDP	26.9	27.1	29.0	29.2	30.9	30.6	28.4	29.3	29.4	29.1
Exports/GDP	30.0	29.3	27.6	29.3	31.7	30.9	30.4	30.3	30.3	30.2
Real exports growth	5.6	2.9	(2.4)	14.9	8.6	(0.6)	(0.5)	4.3	3.0	3.0
Unemployment rate	4.0	3.8	4.4	5.0	3.8	3.5	4.0	3.8	3.5	3.5
External indicators (%)										
Current account balance/GDP	3.0	3.4	4.9	4.0	3.9	5.0	4.0	3.5	3.5	3.3

Table 1

Israel--Selected indicators (cont.)

	2018	2019	2020	2021	2022	2023	2024f	2025f	2026f	2027f
Current account balance/CARs	8.0	9.5	14.6	11.0	10.2	13.1	10.7	9.3	9.4	9.0
CARs/GDP	37.2	36.0	33.4	36.0	38.3	38.0	37.3	37.6	37.1	36.4
Trade balance/GDP	(4.5)	(3.8)	(2.8)	(4.4)	(5.0)	(3.9)	(4.3)	(4.9)	(4.7)	(4.5)
Net FDI/GDP	4.1	2.2	4.0	1.8	2.4	1.3	(1.5)	1.0	2.5	2.5
Net portfolio equity inflow/GDP	(4.1)	(1.5)	(5.2)	(0.7)	1.3	0.2	(2.0)	(2)	(2)	(2.0)
Gross external financing needs/CARs plus usable reserves	66.1	65.0	60.2	58.5	57.3	56.9	56.4	56.8	56.5	56.7
Narrow net external debt/CARs	(46.6)	(51.5)	(68.7)	(66.9)	(54.6)	(68.0)	(67.4)	(66.6)	(65.7)	(65.1)
Narrow net external debt/CAPs	(50.7)	(56.9)	(80.4)	(75.2)	(60.8)	(78.3)	(75.5)	(73.4)	(72.6)	(71.5)
Net external liabilities/CARs	(98.4)	(110.2)	(135.2)	(89.8)	(80.2)	(108.1)	(123.3)	(128.4)	(130.4)	(132.7)
Net external liabilities/CAPs	(107.0)	(121.8)	(158.3)	(100.9)	(89.4)	(124.4)	(138.1)	(141.5)	(144.0)	(145.9)
Short-term external debt by remaining maturity/CARs	27.7	26.5	29.9	27.0	28.2	27.2	27.0	26.3	24.4	23.2
Usable reserves/CAPs (months)	10.6	10.6	12.9	13.3	14.2	13.9	14.3	14.0	13.7	13.4
Usable reserves (mil. $)	115,279	126,014	173,297	212,992	194,218	204,694	215,010	222,027	229,549	237,629
Fiscal indicators (general government; %)										
Balance/GDP	(4.4)	(4.5)	(11.4)	(5.3)	(1.8)	(6.7)	(8.0)	(5.0)	(4.0)	(3.5)
Change in net debt/GDP	3.0	3.0	9.3	2.6	0.7	4.5	8.4	5.0	3.7	3.5
Primary balance/GDP	(1.6)	(1.8)	(8.8)	(2.7)	0.6	(4.4)	(5.3)	(2.0)	(1.0)	(0.5)
Revenue/GDP	36.1	35.3	34.5	36.9	37.5	34.7	35.0	35.2	35.2	35.2
Expenditures/GDP	40.4	39.8	45.9	42.2	39.3	41.5	43.0	40.2	39.2	38.7
Interest/revenues	7.7	7.6	7.8	7.0	6.4	6.9	7.8	8.4	8.6	8.5
Debt/GDP	60.1	59.2	70.9	67.8	60.5	61.9	68.9	69.3	69.2	68.8
Debt/revenues	166.7	167.7	205.6	183.9	161.4	178.4	196.7	196.8	196.7	195.6
Net debt/GDP	58.0	57.9	67.4	63.0	57.2	58.5	65.5	66.1	66.2	66.0
Liquid assets/GDP	2.1	1.4	3.5	4.8	3.3	3.5	3.4	3.2	3.0	2.8
Monetary indicators (%)										
CPI growth	0.8	0.8	(0.6)	1.5	4.4	4.2	2.3	2.0	2.0	2.0

Table 1

Israel--Selected indicators (cont.)

	2018	2019	2020	2021	2022	2023	2024f	2025f	2026f	2027f
GDP deflator growth	0.7	1.9	1.0	2.1	4.7	3.9	2.0	2.0	2.2	2.4
Exchange rate, year-end (LC/$)	3.75	3.46	3.22	3.11	3.52	3.63	3.80	3.80	3.70	3.70
Banks' claims on resident non-gov't sector growth	6.2	4.9	4.8	14.2	13.4	6.0	3.0	7.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	70.3	69.8	73.5	75.2	76.5	76.5	76.9	76.8	76.3	75.6
Foreign currency share of claims by banks on residents	4.4	3.7	4.1	3.9	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	19.7	19.1	18.3	19.6	19.5	N/A	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(1.9)	1.1	(3.9)	6.5	4.3	(8.4)	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. f--Forecast. 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 that promotes sustainable public finance and balanced economic growth. Given that relations between Israeli-Jews, Israeli-Arabs, and Palestinians could be strained, we consider that Israel's civil society is subject to ethnic tensions.
Economic assessment	1	Based on GDP per capita ($) as per the Selected Indicators table above.
External assessment	1	Based on narrow net external debt (% of current account payments) and gross external financing needs (% of current account receipts plus usable reserves) as per the Selected Indicators table above.
Fiscal assessment: flexibility and performance	4	Based on the change in net general government debt (% of GDP) as per the Selected Indicators table above.

Table 2

Israel--Ratings score snapshot (cont.)

Key rating factors	Score	Explanation
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenues) as per the Selected Indicators table above.
Monetary assessment	2	Managed-float exchange-rate regime. The central bank has a track record of operational independence. It uses market-based monetary instruments and has the ability to act as a lender of last resort. Consumer price index as per the Selected Indicators table above; the local currency financial and capital markets are deep.
Indicative rating	aa-	
Notches of supplemental adjustments and flexibility	-1	Event risk related to cases of rapidly rising external political crises, such as a large-scale war with Iran or confrontation with Hezbollah.
Final rating		
Foreign currency	A+	
Notches of uplift	0	Default risks do not apply differently to foreign-and local-currency debt.
Local currency	A+	

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

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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 History, April 10, 2024
- Sovereign Ratings List, April 10, 2024
- Sovereign Risk Indicators, April 8, 2024. Interactive version available at http://www.spratings.com/sri
- Sovereign Ratings Score Snapshot, April 2, 2024

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

Downgraded

	To	From
Israel		
Sovereign Credit Rating	A+/Negative/A-1	AA-/Negative/A-1+
Transfer & Convertibility Assessment		
Local Currency	AA	AA+
Israel		
Senior Unsecured	A+	AA-

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.