Rating Action: Moody's affirms Israel's A1 government rating; outlook remains stable

Global Credit Research - 11 Aug 2016
New York, August 11, 2016 -- Moody's Investors Service ("Moody's") has today affirmed Israel's A1/(P)A1 issuer and government bond ratings with a stable outlook.

Moody's decision to affirm Israel's A1 rating with a stable outlook balances the following key rating factors:

1.) The country's economic resiliency, which derives from very high economic and institutional strengths, reflected in its strong and improving external position;

2.) The government's favorable fiscal dynamics in the recent past, although at risk in light of revisions to the budget rules; and

3.) Israel's susceptibility to geopolitical risk, which requires substantial budget allocations to defense on an ongoing basis.

Outlook Actions:

..Issuer: Israel, Government of

...Outlook, Remains Stable

Affirmations:

..Issuer: Israel, Government of

...Issuer Rating, Affirmed A1

...Senior Unsecured Medium-Term Note Program, Affirmed (P)A1

...Senior Unsecured Regular Bond/Debenture, Affirmed A1

...Senior Unsecured Shelf, Affirmed (P)A1

Moody's has also maintained Israel's Aa3/P-1 country ceilings for foreign and domestic currency debt, its Aa3/P-1 country ceiling for domestic currency deposits and its A1/P-1 country ceilings for foreign currency bank deposits. These ceilings represent the highest possible rating that an issuer domiciled in Israel can achieve.
RATINGS RATIONALE

FIRST FACTOR: THE RESILIENT ECONOMY AND ROBUST EXTERNAL POSITION DRAWS ON VERY HIGH ECONOMIC STRENGTH

Israel's A1 rating is supported by its durable economy and robust institutions, which have enabled the country to successfully weather global and domestic shocks as well as geopolitical challenges with limited disruption to its economic stability. The country benefits from a resilient dynamism and tight security structures. Furthermore, Israel can also depend upon financial support from the global Jewish community, mainly via the Israel Bonds program, and the US government, especially in an emergency.

Already a wealthy advanced economy, Israel's growth has averaged 4% over more than a decade, exceeding that of its OECD and rating peers, with low volatility. Exports however, an important contributor to this past growth, have slackened in recent years, in part due to a strong shekel. Still, the current account remains in surplus and the economy continues to grow close to its estimated 3% potential, led by private consumption. Productivity is lagging though, mainly due to the lack of competition between low value-added industries in the non-tradeables sector of the economy, a stark contrast to the highly competitive high-tech niche.

The economy's resilience derives in large part from its diversification and innovation, comprising established and start-up industries ranging from agriculture to pharmaceuticals, electronics and other high-technology products and services. Israel ranks third, behind Switzerland and Finland, in the World Economic Forum's latest Global Competitiveness rankings, driven by its research institutions and the labor force's capacity for innovation.

The recent discovery and exploitation of sizeable offshore gas reserves provide Israel with enhanced energy security, meanwhile its development of additional gas fields presages exports of gas to several markets in the region as well as to the EU. Israel's current account and balance of payments have already been in surplus for more than a decade, shifting the country's net external debt position into a surplus of 40% of GDP last year. The central bank's foreign currency reserves are at an all-time high of nearly $100 billion, i.e. roughly one third of GDP. This strong external position is yet another reflection of the economy's resiliency.

SECOND FACTOR: FAVORABLE FISCAL DYNAMICS PUT AT RISK DUE TO REPEATED REVISIONS TO FISCAL RULES

Israel's domestic politics are noisy, especially surrounding government budget formation, and the government's medium-term fiscal rules have been repeatedly revised for various reasons, most notably to increase spending beyond previously agreed ceilings. Still, the fiscal dynamics have been favorable almost without interruption over the past 13 years in spite these constant revisions. Once again in 2016, the budget deficit outcome is likely to be lower than the targeted 2.9% of GDP, due to the more tax-intensive nature of domestic demand-led growth, which is bolstering revenues above expected levels.

Whereas the unfunded spending concessions that were made last year to meet the demands of
individual coalition parties did not endanger the 2016 outcome because of the better than expected revenue picture, they have complicated the formation of the 2017 budget. New changes to fiscal rules set only last November will be required again this year if the two-year budget proposal for 2017-18 announced on 8 August is made into law.

In addition to higher expenditure in various areas such as defense than would be allowed under the current spending ceiling, the proposal also specifies individual and corporate tax cuts that are likely to undermine the revenue buoyancy that has contributed to lower than budgeted deficits in recent years. The combination of higher spending and tax cuts also means that the budget proposal could compromise the long-held political consensus around reducing government debt: Moody's estimates that deficits of the size now proposed in the budget proposal would lead the debt-to-GDP ratio to rise slightly between the end of 2016 and the end of 2018.

THIRD FACTOR: SUSCEPTIBILITY TO GEOPOLITICAL RISK IS A RATING CONSTRAINT

Israel's credit profile is susceptible to geopolitical risk, representing a constraint to the sovereign's A1 rating. That said, and despite the present conflicts in the Middle East, Israel's security situation has rather improved in the recent past. Security threats are contained owing to the strength and determination of the Israeli body politic (including the defense forces) as well as the financial and material support of the United States. Furthermore, its considerable military apparatus and technological advantages have led to a significant capacity for deterrence, particularly against traditional militaries.

However, whereas the proliferation of conflicts in Israel's immediate neighborhood (Syria and Iraq in particular) as well as those that have traditionally been conducted by proxy (Hezbollah, Iran, Lebanon) may not have more than an intermittent impact on Israeli economic activity, they do result in a diversion of government resources to the security effort. Although defense spending has been steadily decreasing in relative terms, it remains the largest single item in the government's budget, absorbing resources that could otherwise go to growth-enhancing spending such as education and infrastructure. Israel's outlays on defense totaled 5.4% of GDP in 2015, placing the country as the sixth largest military spender (relative to GDP) in the world.

WHAT COULD RESULT IN AN UPGRADE/DOWNGRADE

Israel's A1 government bond ratings would come under positive rating pressure if government budget deficits continued to be contained enough to lower the government gross debt-to-GDP ratio significantly. Also credit positive would be an easing of regional tensions or progress on a peace agreement with the Palestinians that reduced local antagonisms. Finally, a meaningful improvement in Israel's regulatory framework that boosted investment and productivity would support Israel's creditworthiness.

Downward pressures on Israel's government bond ratings would develop if geopolitical developments disrupted Israel's economic stability or if the government's commitment to fiscal discipline, in particular the consensus around reducing the government's debt to GDP ratio, was
to wane.

GDP per capita (PPP basis, US$): 33,656 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.5% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -1% (2015 Actual)


Current Account Balance/GDP: 4.9% (2015 Actual) (also known as External Balance)

External debt/GDP: 30.2% (2015 Actual)

Level of economic development: Very High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 9 August 2016, a rating committee was called to discuss the rating of the Israel, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/framework, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become less susceptible to event risks.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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