Euler Hermes Economic Research

Country Report

Israel

Gas can fire the economy, but domestic and regional concerns

General Information

GDP	USD242.929bn (World ranking 43, World Bank 2012)
Population	7.91 million (World ranking 97, World Bank 2012)
Form of state	Parliamentary Democracy
Head of government	Benyamin NETANYAHOU
Next elections	legislative, January 2017

Strengths

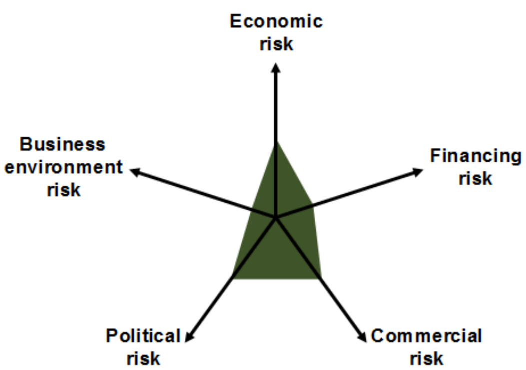
- Overall political stability, with entrenched democratic system, including peaceful transfers of power and effective rule of law.
- Strong military.
- U.S. political and economic support.
- High incomes.
- Relatively good data transparency.
- Classification in MSCI indices as developed market economy. Member of OECD.
- Offshore gas reserves provide potential for future energy independence and limitation of import costs.
- Strong scientific environment, with the world's highest ratio of R&D expenditure to GDP.
- Sound banking sector and vibrant hi-tech industries.

Weaknesses

- Protracted conflict with the Palestinians, uneasy links with Lebanon and Syria and poor relations with Iran contribute to security concerns, constrain growth and can limit the effectiveness of economic policy.
- Unstable coalition governments.
- Although there were little direct contagion effects from the Arab Spring, social protests using similar communication techniques emerged in mid-2011, although protests focus on social factors and job prospects, rather than regime change.
- Dependence on U.S. economic cycle and close links with that country include grants and aid that can be rescinded.
- High public debt in nominal terms (67% of GDP).
- High short-term external debt (when including banking sector liabilities).

Country Rating

BB1



Source: Euler Hermes

Trade structure

By destination/origin (% of total)

Exports		Rank		Imports
United States	28%	1	13%	United States
China, Hong Kong SAR	8%	2	7%	China
United Kingdom	6%	3	6%	Germany
Belgium	5%	4	6%	Switzerland
China	4%	5	5%	Belgium

By product (% of total)

Exports		Rank		Imports
Non metallic mineral products	28%	1	20%	Petroleum and related products
Medicinal and pharmaceutical products	10%	2	12%	Non metallic mineral products
Electrical machinery, apparatus and appliances, n.e.s.	10%	3	7%	Electrical machinery, apparatus and appliances, n.e.s.
Chemical materials and products	5%	4	6%	Road vehicles
Telecommunication and sound recording apparatus	5%	5	4%	Other industrial machinery and parts

Source: UNCTAD (2012)

Recent growth and price data require countervailing responses from the authorities

GDP growth was +2.5% y/y in H1 2014 but there was a q/q contraction in Q3 as a result of conflict with some Palestinian groups. This resulted in reduced economic activity, particularly in the tourist sector but also in domestic consumption and export trade. While some rebound is expected, the recovery may be muted by security issues in Jerusalem. Of particular concern for policymakers is the country's slide into deflationary conditions. Weakening growth and deflation are likely to be a focus of policy implementation going forward.

GDP growth is below trend but will rebound (moderately) in 2015 and natural gas output allows for stronger expansion going forward

A relatively open economy leads to Israel's growth pattern mirroring that of the average for the region and for emerging markets as a whole (see chart). With close links with the U.S. (accounting for almost 30% of Israeli exports and 13% of imports) GDP growth is also closely correlated with the U.S. business cycle. Following two good growth years in 2010 and 2011 (+5.8% and +4.2%, respectively), GDP increased by +3.3% in 2012 and again in 2013.

EH expects annual GDP growth in 2014 and 2015 of +2.5% and +3.5%, respectively, compared with a long-term average of +4.4% (ten-year period to end-2013). Underpinning growth are sound and balanced economic management strategies and development of the country's offshore natural gas fields. In June 2013, official approval was granted for some output from Israel's natural gas fields to be exported. A limit was set at export sales of 40% of production. As a result, the gas sector will provide a boost to GDP, provide an improved longer-term independence in energy supply and underpin the trade and current accounts. Israel's deepwater gasfields of Tamar (output from March 2013) and Leviathan (commercial output from 2017) are part of an East Mediterranean gasfield that is estimated to contain around 1 trillion cubic feet, at least.

The spectre of deflation may spur unconventional monetary actions

Karnit Flug was appointed governor of the BoI in October 2013 and the overall stance on monetary policy has not altered significantly since then, although the current challenges now appear deeper. The rate of growth in prices in the economy has been relatively low in recent years and inflationary expectations are usually well managed by the authorities, with the independent central bank's target range of 1-3% growth in consumer prices broadly maintained, despite high oil prices (fuels account for around 20% of the total import bill) in 2011- late 2014.

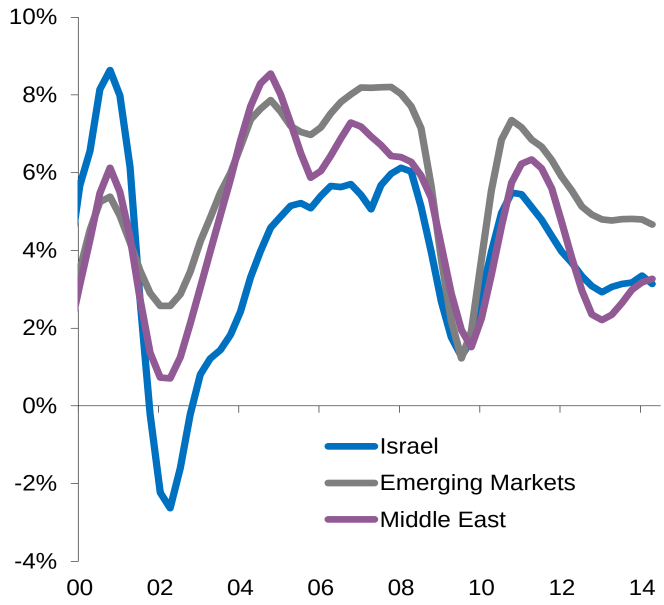
However, consumer prices fell -0.3% y/y in October 2014 and this was the second consecutive month of decline. Moreover, low food prices and a currently lower oil price that alleviates pressures on energy costs are likely to continue. These will weigh against headline inflationary pressures and offset imported inflation because of a weak ILS. Overall, EH expects the rate of inflation will be below the target range at end-2014 and remain at the bottom of the 1-3% range in 2015. However, the monetary authorities will be wary of the spectre of deflation and, with the key policy interest rate already low at 0.25%, a monetary stimulus may require the BoI to implement unconventional policies to boost demand.

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	3.3	3.3	2.5	3.5
Inflation (%, end-year)	1.6	1.8	0.5	1.3
Fiscal balance (% of GDP)	-3.9	-3.2	-3.1	-3.4
Public debt (% of GDP)	66.9	66.2	67.7	67.2
Current account (% of GDP)	0.8	2.4	2.3	3.1
External debt (% of GDP)	37.8	32.7	30.8	29.3

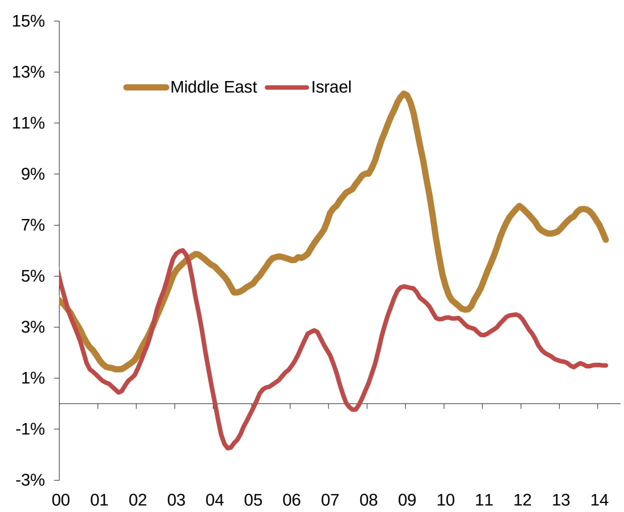
Sources: IHS, national sources, Euler Hermes

GDP growth (y/y, 4 qtrs cumulated %)



Sources: IHS, Euler Hermes

Inflation (%)



Sources: IHS, Euler Hermes

Public finances

The fiscal authorities are making a determined attempt to improve the budgetary accounts to ease deficit financing and the debt burden, but also to help maintain the country's sovereign rating. EH expects the fiscal deficit will ease only moderately in 2014 to the equivalent of -3.1% of GDP, following -3.2% in 2013. In 2015, EH expects upwards pressure on state expenditure (including military) and the deficit will rise to -3.4% of GDP.

The public debt/GDP ratio was over 90% in 2001-05 but management of the fiscal accounts reduced it to 75% in 2009 and further remedial policy action will reduce that to just under 68% in 2014.

External accounts boosted by weak oil prices

External trade is critical for such a small country with limited natural resources to exploit. Exports of merchandise goods are equivalent to over 21% of GDP and imports of goods to 24.5% (2013). Total exports (including services) are equivalent to 33% of GDP and total imports are over 31.5%. Israel has a significant high-tech sector and its export base reflects its competitive advantage derived from its human capital. After a relatively strong surplus on the current account in 2010 (+3.4% of GDP) weaker balances reflected a weak global economic environment that reduced demand for Israel's exports, while import demand remained relatively buoyant (almost 20% of the import bill is accounted for by energy requirements). Israel is a beneficiary of official transfers, particularly from the U.S., and these bolster the external accounts. Current relatively weak oil prices, if maintained, will reduce the import bill at a time when exports of natural gas are increasing. As a result the current account surplus could reach 3.1% of GDP in 2015.

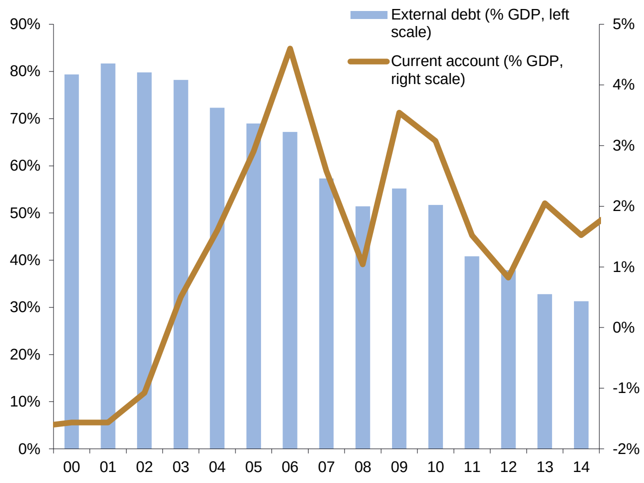
Import cover remains strong at over 10 months, with FX reserves currently around USD84 billion and eclipsing total short-term external debt (usually rolled over with comfort) and principal repayments, so financing problems stemming from the external sector are unlikely.

Planning for the future

In March 2013, the central bank added a new policy directive as it announced that it will now purchase FX to offset potential undue effects on the ILS of output and sales of natural gas from the Tamar offshore field. Even so, the ILS continues to be vulnerable to any potential adverse domestic political developments or regional ruptures.

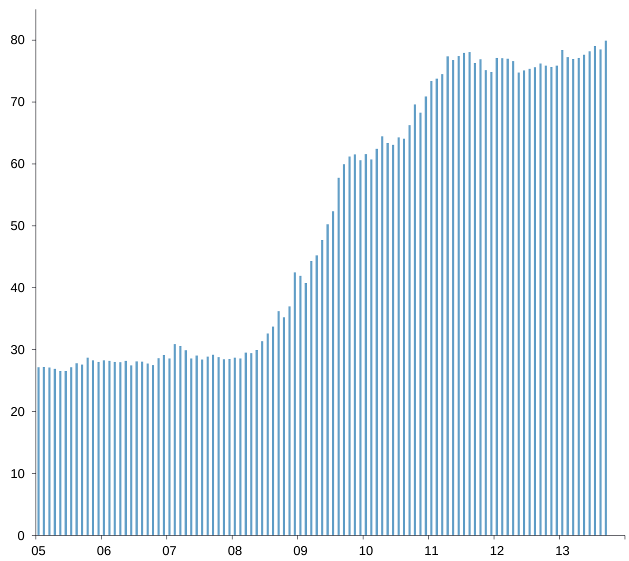
Israel has the world's highest ratio of R&D expenditure to GDP (almost 4%), enabling the growth of a strong scientific environment and development of high-tech exports of goods and services.

External debt and current account balance (% of GDP)



Sources: IHS, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: IHS, Euler Hermes

Contact Euler Hermes Economic Research Team

research@eulerhermes.com

Last review: 2014-12-10
Country Risk Analyst:
Andrew Atkinson
andrew.atkinson@eulerhermes.com