Euler Hermes Economic Research

Country Risk Analysis

Israel

Strong economy, but security 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	2014, presidential

Strengths

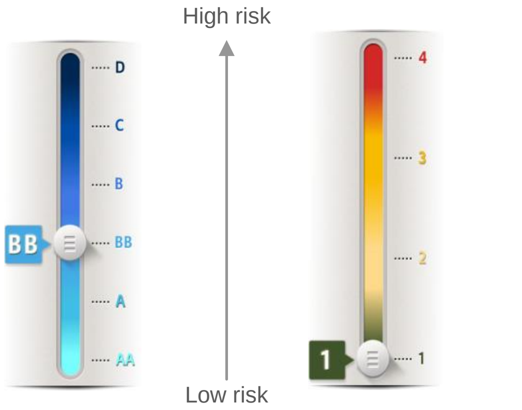
- Overall political stability, with entrenched democratic system, including peaceful transfers of power and effective rule of law.
- Strong military.
- US political and economic support.
- High incomes.
- Relatively good data transparency.
- Classification in MSCI indices as developed market economy.
- 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

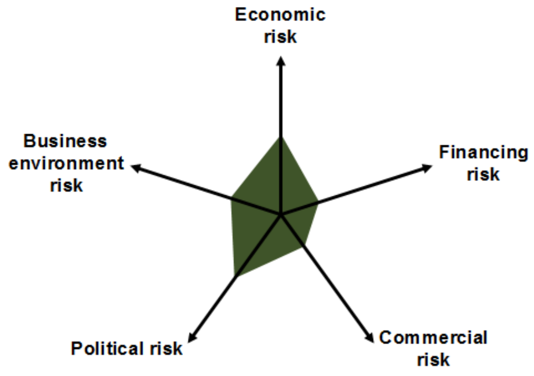
- Protracted conflict with the Palestinians, uneasy links with Lebanon and Syria and poor relations with Iran contribute to security concerns, constrain growth and can limit the effectiveness of economic policy.
- Unstable coalition governments.
- Although there were little direct contagion effects from 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 US economic cycle and close links with that country include provision of grants and aid.
- High public debt in nominal terms (72% of GDP).
- High short-term external debt (when including banking sector liabilities).

Country Rating BB1

Country Grade **Country Risk Level**



Risk Dimensions



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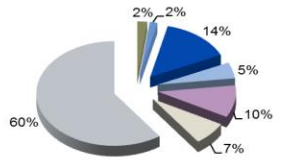
Economic Structure

GDP breakdown (% of total, 2011)



Trade structure (% of total, 2011)

By destination/origin

Exports		Rank		Imports
United States	30%	1	12%	United States
Hong Kong	8%	2	7%	Germany
Belgium	6%	3	7%	China
India	5%	4	6%	Belgium
United Kingdom	5%	5	5%	Italy

By product

Exports		Rank		Imports
Jewellery, Works Of Art	31%	1	12%	Crude Oil
Pharmaceuticals	12%	2	11%	Jewellery, Works Of Art
Precision Instruments	5%	3	6%	Refined Petroleum Products
Toiletries	5%	4	5%	Cars And Cycles
Fertilizers	4%	5	3%	Specialized Machines

Sources: Chelem, UnctadStat, IHS Global Insight, Euler Hermes

Economic Forecast

	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	1.1	5.0	4.6	3.2	3.0	4.0
Inflation (%, end-year)	4.0	2.7	2.2	1.6	1.7	2.5
Fiscal balance (% of GDP)	-6.3	-4.6	-4.2	-4.9	-3.5	-1.8
Public debt (% of GDP)	75.3	71.5	69.7	68.2	72.1	69.7
Current account (% of GDP)	3.6	2.9	0.1	-1.5	-0.3	0.3
External debt (% of GDP)	48.0	48.9	42.0	42.1	38.8	38.0

Sources: IHS Global Insight, National sources, Euler Hermes

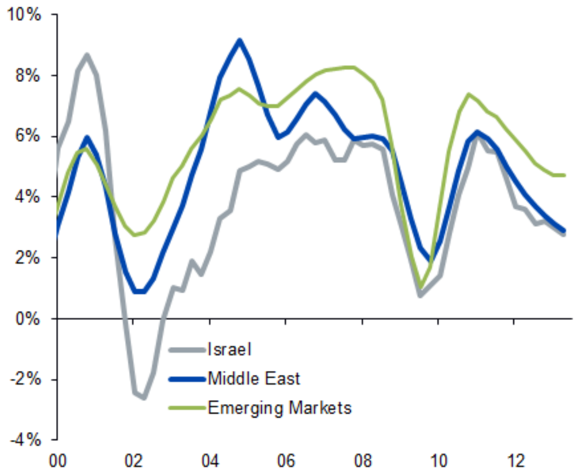
Economic Growth

Growth rates remain adequate but below potential

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 US (accounting for one-third of Israeli exports and one-fifth of imports) GDP growth is also closely correlated with the US business cycle. Following two good growth years in 2010 and 2011 (+5% and +4.6%, respectively), GDP increased by +3.2% in 2012.

The main growth drivers currently are construction, infrastructure projects and the nascent natural gas industry. Low interest rates are also supporting growth. However, the export-dependent economy is expanding below potential, reflecting the slow global recovery and because of the impact of some austerity measures, including state expenditure cuts and tax increases.

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



Sources: IHS Global Insight, Euler Hermes

Natural gas to be a growth driver going forward

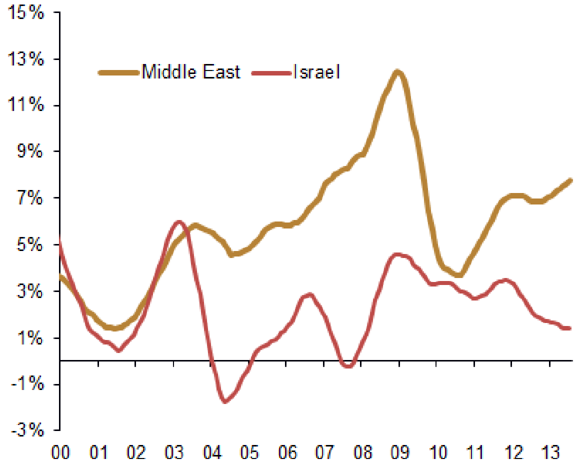
EH expects annual GDP growth in 2013 and 2014 of +3% and +4%, respectively, compared with a long-term average of +4.1% (ten-year period to end-2012). Underpinning growth are sound and balanced economic management strategies and development of the country's offshore natural gas fields.

Economic Policies

In October 2013 and after four months of deliberation, Karnit Flug was appointed governor of the BoI, succeeding Stanley Fischer, who left the post at end-June. Flug had been deputy governor, so a significant redirection of monetary policy appears unlikely. Meanwhile, 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.

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. The Tamar deepwater field (estimated reserves of 280 billion cubic metres) began production in March but the Leviathan field (estimated 530 bcm) is not scheduled to begin output until 2017.

Inflation rate (%)



Sources: IHS Global Insight, Euler Hermes

Low inflationary environment

The rate of growth in prices in the economy is relatively low and inflationary expectations are usually well managed by the authorities. The independent central bank's monetary policy is currently based around an inflation target range of 1-3% growth in consumer prices and, despite high oil prices (fuels account for around 20% of the total import bill). EH expects the rate of inflation will remain within these bounds in 2013 and 2014.

The exchange rate is likely to remain relatively stable in 2013-14, with the central bank moderating any significant movement through policy adjustments and with the FX reserves to be able to do so. In March, the central bank added a new policy directive as 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. However, the ILS continues to be vulnerable to any potential adverse domestic political developments or regional ruptures.

General government gross debt (% of GDP)

Sources: IHS Global Insight, Euler Hermes

Fiscal deficit being addressed

This year's austerity budget showed that economic management was addressing the need to limit fiscal deficits, debt accumulation and the need to protect the country's sovereign credit rating. Measures adopted included spending cuts (including on military expenditure and health services) and tax increases (income and corporate). EH expects the fiscal deficit to fall to around -1.8% of GDP in 2014, following -3.5% in 2013 and -4.9% in 2012.

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 70% in 2014. Relatively sound fiscal actions and associated deficit and debt reductions are likely to help Israel maintain its sovereign ratings.

Importance of external trade and focus on exports from the high-tech sector

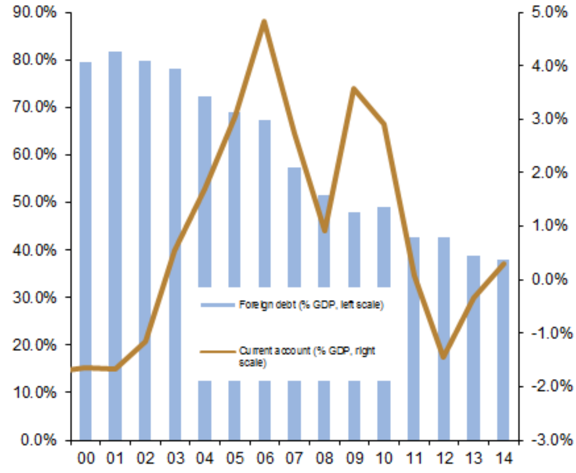
External trade is critical for such a small country with limited natural resources to exploit. Exports of goods are equivalent to 20% of GDP (2013) and imports of goods to 24%. Total exports are equivalent to almost 31% of GDP and total imports are over 33%. Israel has a significant high-tech sector and its export base reflects its competitive advantage derived from its human capital. Israel has the world's highest ratio of R&D expenditure to GDP (4%), enabling the growth of a strong scientific environment and development of high-tech exports of goods and services.

Relatively strong surpluses on the current account in 2009 and 2010 (+3.6% and +2.9% of GDP, respectively) turned to deficits in 2012 and 2013 (-1.5% and -0.3%). Deterioration in the current account balance in this period largely reflects the 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 US, and these bolster the external accounts. Although export revenues from the country's nascent offshore gas sector are unlikely in the forecast period, they offer scope for substantial revenue generation going forward.

External debt ratios are comfortable and import cover is high

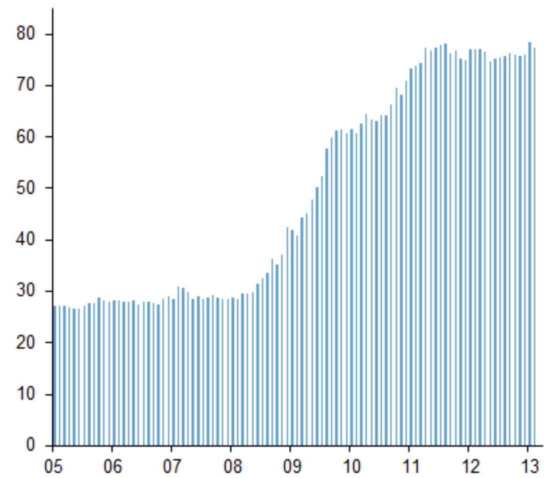
External debt and its servicing are relatively comfortable, particularly as there is some distortion in the official data from the inclusion of banking items. Import cover remains strong at over 10 months, with FX reserves currently around USD78 billion and eclipsing total short-term external debt (usually rolled over with comfort) and principal repayments, so financing problems stemming from the external sector are unlikely.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, Euler Hermes

FX reserves (USDbn)



Sources: IHS Global Insight, Euler Hermes