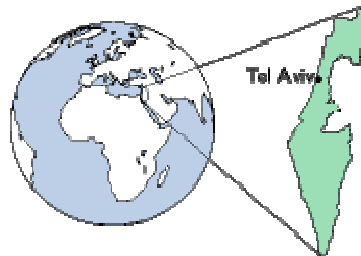


COUNTRY REVIEW

Israel



28 May 2010

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

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Strengths

- Overall political stability, with entrenched democratic system, including peaceful transfers of power and effective rule of law
- Military superiority and diplomatic agreements limit regional security threats
- US political and economic support
- High incomes
- Strong demand from diaspora for government paper
- Current account surplus and strong FX reserves (import cover of around 9 months)
- Relatively good data transparency
- Supportive structural business environment
- Sound banking sector and vibrant hi-tech industries

Weaknesses

- Protracted conflict with the Palestinians, uneasy links with Lebanon and poor relations with Iran contribute to security concerns, constrain growth and can limit the effectiveness of economic policy
- Unstable coalition governments
- Dependence on US economic cycle and lingering need for US grants and aid
- Fiscal deficits and high public debt (70-80% of GDP)
- High short term external debt

Key Risks

- Israeli-Iranian hostilities could involve use of nuclear armaments and, in any case, would result in widespread regional turmoil
- The sheqel could come under strong downward pressure if risk aversion and deleveraging re-escalate

Country Risk Assessment

Ratings	Israel		Median Grade BB	UAE	Peers	
	Latest	Previous			South Africa	Malaysia
Systemic Political Risk:	P2-	P2-	P2+	P2+	P2-	P2+
Systemic Economic Risk:	E3	E3	E3	E3	E3	E2
ME rating:	ME3	ME3	ME3	ME3	ME3	ME2
<i>Structure</i>	1.6	1.6	3.8	5.7	2.3	2.3
<i>Policy</i>	3.8	2.8	4.3	3.9	4.2	4.3
<i>Solvency</i>	2.8	3.2	1.6	1.9	1.0	1.3
<i>External Liquidity</i>	4.3	4.8	3.3	3.3	5.8	2.8
SBE rating:	SBE2	SBE2	SBE2	SBE3	SBE3	SBE2
COUNTRY GRADE:	BB	BB	BB	BB	BB	A

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Jerusalem
Population:	7.05 mn (2008)
GDP:	USD 202102 mn (2008)
Currency:	New Israeli Sheqel (ILS)
Form of state:	Parliamentary democracy
Head of government:	PM Binyamin Netanyahu
Next elections:	Parliamentary by February 2013

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2009	2010f
Agriculture 3.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry 31.0%	Inflation (% , av) *	-0.1	1.3
Services 66.0%	Dated Brent (USD/b)	61.0	80.0
* Major economies			

Main Exports (% of total, 2009)		Main Imports (% of total, 2009)	
Electronic goods, components etc. 26.0%		Diamonds 17.0%	
Chemicals 25.0%		Machinery & equipment 11.0%	
Diamonds 22.0%		Fuel 11.0%	
		Chemicals 8.0%	
Lead Export Markets (% of total exports, 2009e)		Lead Import Markets (% of total imports, 2009e)	
US 39.0%		US 12.0%	
Belgium 9.0%		Belgium 7.0%	
Hong Kong 8.0%		China 7.0%	
India 5.0%		Switzerland 6.0%	

Basic indicators

Selected economic indicators	2006	2007	2008	2009	2010f
Nominal GDP (USD mn)	145,845	166,990	202,102	194,790	216,107
Population (mn)	6.81	6.93	7.05	7.17	7.29
GDP per capita (USD)	21,416	24,097	28,667	27,171	29,644
Real GDP growth (% yr/yr)	5.3	5.2	4.0	0.7	3.0
Inflation (% , average)	2.1	0.5	4.7	3.3	2.0
Fiscal balance (% of GDP)	-0.8	0.0	-2.1	-5.0	-3.7
Current account balance (% of GDP)	5.1	2.9	0.7	3.7	2.8
External debt/GDP (%)	59.3	53.4	42.6	44.5	41.6
External debt/Exports of goods & services (%)	108.9	118.5	120.0	114.0	110.0
Debt-service ratio (%)	10.7	10.5	11.2	12.3	10.5
Foreign exchange reserves (USD mn)	29,011	28,406	42,324	59,091	62,000
Import cover (months)	4.9	4.0	5.3	9.7	9.1
Exchange rate assumption, ILS:USD (av)	4.46	4.11	3.59	3.93	3.75
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

The political environment is highly developed and **transfers of power occur peacefully within a democratic framework**. The rule of law is well established, the judiciary is independent and corruption levels—although evident—are modest by emerging economy standards. Indeed, Israel was this year invited to become **a member of the OECD**. However, policymaking is constrained by an **electoral system that tends to produce unstable coalition governments dependent on small non-secular parties for survival**. Nevertheless, overall systemic political stability resulting from domestic factors is not deemed to be at risk.

For many years, domestic politics was dominated by the Labour and Likud parties and the coalition governments they formed (sometimes together). However, in elections in 2006, a new centrist organisation, Kadima (Forward), won the most seats and formed a government. This administration was beset with allegations of corruption and financial malpractice, as well as criticism of the handling of the country's attack on Hezbollah and invasion of southern Lebanon in 2006. In elections in February 2009, Kadima narrowly won the most parliamentary seats but could not forge a **coalition, which was then achieved by Likud under the premiership of Binyamin Netanyahu**. The current coalition, in addition to Likud, includes the far-right Yisrael Beiteinu, the religious Shas and Labour, thereby continuing Israel's fractured system of governance.

Although PM Netanyahu has publicly acknowledged the feasibility of a **"two-state solution" in relation to Israeli-Palestinian affairs, little progress has been achieved in the peace process**. In turn, this complicates the Israeli-US relationship—a fundamental aspect of Israel's international diplomacy—since President Barack Obama has pledged Washington's support for Palestinian statehood. To date, progress in the peace process has been poor largely because of the need to balance domestic Israeli political aspirations within a coalition government and because the Palestinian Authority has had difficulties preventing intermittent attacks on Israeli targets. Moreover, the success of Hamas in parliamentary elections in Palestine in January 2006 promoted an intensification of rivalries between Fatah and Hamas, which resulted in **Gaza and the West Bank becoming, de facto, separate entities**. Israel deals with the Palestinian Authority in the West Bank and renewed donor funding is channelled only to this area. Outstanding issues such as the status of Jerusalem and of Palestinian refugees appear far from resolution.

International relations centre on close links with the US. **Washington's strong political, financial and defence support (re-affirmed by the Barack Obama administration)** has been key to Israel's emergence as the dominant economic and military force in the Middle East. Over time, peace agreements with Egypt and Jordan—and commercial links with some Gulf states—reduced external security threats, and the overthrow of the Saddam Hussein regime in Iraq removed one of the main regional threats to stability. However, regional dynamics changed with the Israeli bombardment of Hezbollah in southern Lebanon in mid-2006. As a result, Israel has antagonised both Syria and Iran (President Ahmadi-Nejad has used inflammatory rhetoric suggesting that Israel should not exist) and there remain **heightened regional concerns relating to security**.

Economic Stability

The economy is categorised as high income by the World Bank—per capita GDP is above USD25,000. Although output is diversified, exports are concentrated in manufactures (including diamonds). Moreover, **reliance on the US for almost 40% of total export earnings** implies that output follows closely US business cycles. Annual average real GDP growth was 5.7% in 1991-2000, 0.3% in 2001-03 (including outright contraction in 2001 and 2002 because of the second Palestinian intifada and the collapse in the global IT sector) and 5% in 2004-08, when the global economy and world trade expanded strongly. With a very **open economy—both exports and imports are equivalent to 40% of GDP**—development is significantly dependent on global economic factors and, accordingly, weak overseas markets for Israeli goods and limited international investment flows into domestic sectors in 2009 resulted in only modest expansion (0.7%) in that year—official projections had earlier indicated a small annual contraction. Uncertainties in the Eurozone and in the pace of global recovery limit the rebound in the Israeli economy and we **forecast around 3% growth in real GDP in 2010**.

Despite Netanyahu and Likud expounding an underlying philosophy that is right-wing, with a strong bias to private sector-led economic activity, the focus of recent policy has been expenditure support for the economy from the government against a background of a very weak global economy. **A fiscal stimulus package** resulted in a budget deficit of around 5% of GDP in 2009. In his previous roles as finance minister and premier, Netanyahu introduced concerted attempts at budgetary control (including privatisation) and these proved successful (along with higher tax receipts because of

stronger growth) in reducing fiscal deficits to below 2% of GDP—approximate balance was achieved in the state budget accounts in 2007—from a trend range of 3-6% of GDP. However, in addition to the recent need to stimulate the economy, spending cuts are difficult to push through with a coalition government heavily dependent on varied political and economic agenda and **military expenditure will remain high**, particularly as the Gaza Strip, southern Lebanon and Iran pose immediate risks. Accordingly, even with some retrenchment this year, relatively large fiscal deficits are likely to remain in the ST. **Public debt to GDP at 70-80% of GDP requires careful management.** Nevertheless, overall financing is unlikely to prove problematic, given the continuing ability to raise funds from domestic bond issuance and from abroad and continuing loan guarantees from the US. However, LT debt sustainability requires there to be a return to the commitment of the previous reform agenda.

Monetary policy in 2010 has moved towards tightening, following **staged cuts in interest rates to offset the economic slowdown in 2009.** However, continuing global concerns are likely to result in only modest increases in policy rates—perhaps a further 50-100bps by end-2010 and thereby remaining low by historic standards. Annual consumer price inflation was only 0.5% yr/yr in 2007, but increased to 4.7% in 2008 as oil prices peaked in mid-year (averaging USD98.5/barrel for the year, compared with USD63/b in 2007). As oil prices eased in 2009, to average USD72/b, inflationary pressures in Israel were reduced—**fuels account for 10-20% of Israel's import bill.** We forecast that inflation will average 2% in 2010, comfortably within the central bank's 1-3% target band. The **exchange rate is likely to remain relatively stable to strong through the remainder of 2010** (averaging USD1=NIS3.75), supported by a current account surplus and an expected positive differential in interest rates between Israel and its trade partners. However, the sheqel will continue to be sensitive to any potential adverse political developments.

The current account balance was in deficit in 2000-02 but surpluses equivalent to 1-3.5% of GDP in 2003-05 and 5% in 2006 resulted from strong export growth, rising service credits (largely tourism) and large (but declining) net transfers that offset increased import costs from a surge in commodity prices. However, weak external demand for Israeli exports and historically high oil prices in 2008 reduced the surplus to around 0.7% of GDP in that year. **With easing oil prices, the current account surplus recovered to 3.7% of GDP in 2009 and we forecast it will be just below 3% this year.** Foreign exchange reserves (FX) totalled USD29bn at the end of 2006, providing an import cover just below five months. Since then, strong inward FDI and other LT debt (and other) inflows have boosted FX to around USD60bn, thereby almost doubling **import cover to nine months.** In 2010, we forecast that total external debt will be equivalent to over 41% of GDP and 110% of export earnings, while the debt service ratio will be 10-11%. However, short term debt data is somewhat distorted through inclusion of banking items that most emerging economies exclude and the external debt data are therefore unlikely to represent potential financing problems.

Structural Business Environment

The business environment is sound and generally above the average of the countries we assess. A broad measure of the institutional environment in which economic activity (and by extension businesses) may or may not flourish is the Heritage Foundation's Index of Economic Freedom (IEF). Israel is classified as "moderately free" and ranks 44 out of 179 countries assessed by this methodology in 2010, above UAE, Malta and Hungary but below Mexico, Kuwait and Oman. Israel ranks 27 out of 182 countries covered by the UN Human Development Index 2009, which provides a proxy for the overall level of development and sophistication of the country concerned, below Hong Kong, Greece and South Korea but above Slovenia, Kuwait and Cyprus. Life expectancy at birth is almost 81 years and adult literacy is 97%. The World Bank's Doing Business 2010 report ranks Israel 29 out of 183 countries in terms of the ease of doing business, well above average in terms of getting credit, investor protection and trading across borders. However, the World Bank notes that enforcing contracts is more time consuming and costly than the regional average, although it involves less procedures. In terms of closing a business, it takes longer and costs more in Israel than the regional average but the recovery rate is significantly superior. Transparency International's Corruption Perceptions Index 2009 rates Israel 32 out of 180 countries covered (above Spain, Portugal and Botswana but below Estonia, Slovenia and UAE).

The financial sector and capital markets are being liberalised. The government is in the process of divesting some of its interests in the banking sector but retains majority control of two out of the top five banks. These top five account for around 95% of the sector's total assets, with the top two responsible for 60%. Despite this concentration, the financial sector is competitive and the IMF appears satisfied with overall capitalisation, liquidity ratios and supervisory and regulatory practices.

Andrew Atkinson

London: +44 (0)20 7860 2577

Charts

