Moody's

Rating Action: Moody's changes outlook on Israel to stable from positive, affirms A1 ratings

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London, April 14, 2023 -- Moody's Investors Service (Moody's) has today changed the outlook on Government of Israel's ratings to stable from positive and affirmed the A1 foreign-currency and local-currency senior unsecured and foreign-currency and local-currency long-term issuer ratings. The foreign-currency senior unsecured shelf and senior unsecured MTN programme ratings have been affirmed at (P)A1.

Israel's backed senior unsecured rating has been affirmed at Aaa. The related issuances benefit from an irrevocable, on-demand guarantee provided by the government of the United States (Aaa stable).

The change of outlook to stable from positive reflects a deterioration of Israel's governance, as illustrated by the recent events around the government's proposal for overhauling the country's judiciary. While mass protests have led the government to pause the legislation and seek dialogue with the opposition, the manner in which the government has attempted to implement a wide-ranging reform without seeking broad consensus points to a weakening of institutional strength and policy predictability.

As a result, the risks on Israel's rating are now balanced, leading to a stable outlook. On the downside, while the deliberations about the exact form of the judicial reform continue, the government has reiterated its intention to change how judges are selected. This means that the risk of further political and social tensions within the country remains. On the upside, if a solution is reached without deepening these tensions, the positive economic and fiscal trends that Moody's had previously identified remain. All in all, the recent events offset the positive developments that had led Moody's to assign a positive outlook in April 2022, which related to strong economic and fiscal performance and the implementation of structural reforms by the previous government.

The affirmation of the A1 ratings reflects Israel's strong economic growth and improving fiscal strength which Moody's expects to continue in its baseline scenario. The economy has proven resilient to many economic and geopolitical shocks over the past decades and has grown at a rapid clip, helped by Israel's globally competitive high-tech industries. Moody's baseline projections assume continued robust growth in the medium term. The government's fiscal metrics have also improved rapidly after the pandemic-induced temporary shock, with the public debt-to-GDP ratio declining by ten percentage points of GDP within two years to 60.7% of GDP in 2022. Moody's expects a further decline towards 55% by the end of next year.

Israel's local currency (LC) and foreign currency (FC) country ceilings remain unchanged. The LC country ceiling at Aaa, four notches above the sovereign rating, balances the limited government footprint in the diversified Israeli economy and external stability against some political and geopolitical risks and the current challenges to the predictability and reliability of institutions and government actions. The FC country ceiling at Aaa, in line with the LC ceiling, reflects very low transfer and convertibility risks, given the very open capital account, strong policy effectiveness as well as the central bank's very large foreign currency buffers of 36% of GDP.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO STABLE FROM POSITIVE

The outlook change to stable from positive is driven by Moody's assessment that the recent events around the government's plans for an overhaul of the judiciary point to a deterioration of Israel's institutional and governance strength, which balances previously identified positive credit trends.

More specifically, the government's plans for an overhaul of the judiciary and the manner in which this reform has been handled have exposed some weakness in Israel's executive and legislative institutions. Compared to many other countries, Israel's institutional set-up relies to an important extent on judicial oversight and review. The country has a unicameral parliament in which the government has a majority, a largely ceremonial role for the president and comparatively weak lower levels of government.

Many in Israel are supportive of some change to the judicial system – businesses complain about the length of court proceedings, and there is a recognition that the role of the Supreme Court could be better defined and its composition be more diverse. The government's initial proposals would not address these concerns effectively. Instead, the wide-ranging nature of the originally proposed changes and the speed with which the government attempted to push them through the Knesset, Israel's parliament, without an attempt to achieve broad consensus point to a weakening of institutions. Also, the predictability of the country's executive and legislative institutions has declined. The proposed changes have triggered mass protests, the calling of a general strike by the General Federation of Labour on 27 March and the refusal of some reserve soldiers and officers to turn up for training.

The bill has now been paused for a month, to give time to find a compromise with opposition parties, under the auspices of the President, consistent with Moody's assessment that despite some weakening the executive and legislative institutions remains strong by global standards. While Moody's does not expect the reforms to be passed in their originally proposed form, it is far from clear whether a compromise can be found; the government has reiterated its intention to change the selection process for judges, implying that the risk of renewed protests remains high.

While the events since the start of the year have shown the strength of civil society, they have also exposed divisions in Israeli society, which run deeper than the judicial changes and will likely keep social and political risks elevated for some time. Greater polarisation would risk undermining policy effectiveness and economic strength over the medium term. Hence, the recent events offset the positive developments that led Moody's to assign a positive outlook in April 2022, which related to strong economic and fiscal performance and the implementation of structural reforms.

RATIONALE FOR AFFIRMING A1 RATINGS

The decision to affirm the A1 ratings reflects Israel's very robust growth potential and proven resilience to repeated economic and geopolitical shocks over many years as well as the government's improving fiscal and debt metrics.

The Israeli economy has grown at a rapid rate over the past several years, averaging 4.1% over the decade to 2022, helped to an important extent by the globally competitive and increasingly diversified high-tech industries. The Bank of Israel estimates the growth potential of the economy at close to 4%, better than that of most other OECD countries.

Even before the current turmoil erupted, growth was generally expected to slow, given the more moderate global environment and significant monetary tightening; the key interest rate now stands at 4.5% compared to 0.1% in March 2022. In its baseline scenario Moody's expects real GDP growth to slow to around 2.6% this year, before accelerating again to around 3.5% in 2024. While a prolongation of the current events poses significant risks to the outlook for Israel's economy, there is so far no indication of material capital outflows or a reconsideration of investments from abroad in Israeli high-tech companies.

Israel benefits from several structural factors underpinning its good growth potential, namely rapid population growth, very strong export capabilities of its high-tech sectors, strong demand for its defense-related exports as well as growing export potential from its natural gas resources. Also, the previous government introduced a series of credit-positive structural reforms which we expect to be maintained and which are supportive of longer-term growth.

Also, Israel's fiscal and debt metrics have improved rapidly after the pandemic-induced temporary shock, with the public debt-to-GDP ratio declining by ten percentage points of GDP within two years to 60.7% of GDP in 2022. Last year, the government recorded a budgetary surplus of around 0.6% of GDP, helped by strong revenue growth and contained expenditure growth as most pandemic-related spending ended. The new government has presented a prudent 2023-24 budget, which targets a budget deficit of just below 1% of GDP for the two years and which has just passed its first reading in the Knesset. Even somewhat higher deficit assumptions, due to lower GDP and revenue growth, will still result in a further decline in the public debt ratio this year and next towards 55% of GDP.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Israel has moderate exposure to environmental risks, reflecting primarily physical climate risks and more specifically water stress risks. Israel's water scarcity reflects its geographical location in a semiarid climate zone. The authorities' sound water management provides an important mitigant, including through drip irrigation systems, seawater desalination and wastewater recycling. Its overall E issuer profile score is therefore moderately negative (E-3).

Social risks have been present for a long time but have now come to the fore in the context of the government's proposal for judicial overhaul. They primarily emanate from Israel's unique demographic composition and challenges related to highly uneven labour market participation rates, as well as large skill and productivity gaps among the country's different population groups, with particularly low labour participation of (ultra-orthodox) Haredi men and Arab women. The share of the ultra-orthodox in the population is expected to increase from 10% currently to over a third by 2065, potentially widening the skill gap further. These differences lead to pronounced income inequalities and in combination with differences in access to healthcare and other basic services give rise to social risks and at times the eruption of violent tensions. Overall, we assess Israel's S issuer profile score as moderately negative (S-3).

Israel's institutions and governance strength remains very high despite some weakening in the context of current events, which have led Moody's to lower its assessment of the quality of executive and legislative institutions. At the same time, civil society and other institutions such as the security establishment have shown themselves to be highly effective checks on the exercise of government power, while it remains to be seen how the strength and independence of the judiciary will evolve going forward. The country's macroeconomic and monetary policy framework is sound and has supported timely policy interventions, although the polarized political environment has tended to weigh on fiscal policy effectiveness. Overall, Israel's G issuer profile score remains positive (G-1).

Israel's ESG Credit Impact Score is moderately negative (CIS-3), reflecting moderate exposure to environmental risk given challenges around water scarcity as well as moderate exposure to social risks due to its uniquely challenging demographic profile, while governance overall remains very strong which contributes to its relatively strong resilience to E and S risks.

GDP per capita (PPP basis, US$): 46,659 (2021) (also known as Per Capita Income)

Real GDP growth (% change): 8.6% (2021) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.8% (2021)

Gen. Gov. Financial Balance/GDP: -4% (2021) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.4% (2021) (also known as External Balance)

External debt/GDP: 33.2% (2021)

Economic resiliency: a1

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

On 11 April 2023, a rating committee was called to discuss the rating of the Government of Israel. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Reflecting the change in outlook back to stable from positive, there is limited upside rating potential over the near term. The outlook could return to positive and the rating be upgraded if the current turmoil were to be resolved in a manner that does not deepen the social tensions between the various demographic groups and secures Israel's strong growth potential. A continuation of the positive fiscal and debt trends would also be a prerequisite for a positive outlook and eventually a higher rating.

Israel's ratings would come under downward pressure if the current tensions were to turn into a prolonged political and social crisis with material negative impact on the economy, possibly linked to substantially lower capital inflows into the important high-tech sector and relocation of Israeli firms abroad. While geopolitical tensions have traditionally not had a major or lasting impact on Israel's economy, a serious escalation of tensions with the Palestinians could endanger Israel's improved relations with some of its neighbours and potentially lead to increased international isolation with negative implications for the export-orientated economy and Israel's economic strength.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/api/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.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.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

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