Rabobank

Country Report

ISRAEL

Summary

Israel's small but technologically advanced free-market economy, located in an important and geopolitically high risk region, was and still is doing remarkably well. The short-term outlook is also encouraging. Real GDP growth exceeds 4% per year and the current account is structurally in surplus. On a net basis Israel is no longer a debtor country. Finds of large gas reserves bode well to reduce its recent but unsecure dependency since 2008 on gas deliveries from Egypt. Capital flight is towards this 'safe haven', which make anti-inflationary measures more pressing. Macro-economic policies are fiscally prudent, aimed at low inflation and also rules-based as stipulated in the new banking law of 2010.

Its internal and geopolitical security position is the overarching negative aspect of its risk profile. Its large and growing Arab minority is a demographic time bomb. Externally, Iran's nuclear ambition are considered a serious danger and new less autocratic governments in neighbouring countries Egypt and Jordan may be pressed to support Palestinian rights. With the Arab Spring unfolding, American and European policies are in flux and tolerance for Israel's polities is declining.

Things to watch:

- US and EU pressure on Israel to accept Palestinian demands
- Size of offshore gas finds

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Israel

National facts	
Type of government	Parliamentary democracy
Capital	Jerusalem
Surface area (thousand sq km)	22
Population (millions)	7.4
Main languages	Hebrew (official)
	Arabic
Main religions	Jewish (76.4%)
	Muslim (16%)
	Arab Christians (1.7%)
Head of State (president)	Shimon Peres
Head of Government (PM)	Binjamin Netanyahu
Monetary unit	New Israeli shekel (ILS)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	217	0.35
Nominal GDP at PPP	218	0.30
Export value of goods and services	80	0.43
IMF quotum (in mln SDR)	928	0.43
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.5	4.2
Agriculture (% of GDP)	3	3
Industry (% of GDP)	31	32
Services (% of GDP)	65	64
Standards of living	*USD*	*% world av.*
Nominal GDP per head	28680	291
Nominal GDP per head at PPP	28847	247
Real GDP per head	21675	271

Social and governance indicators	rank / total
Human Development Index (rank)	15 / 169
Ease of doing business (rank)	29 / 183
Economic freedom index (rank)	43 / 179
Corruption perceptions index (rank)	30 / 178
Press freedom index (rank)	86 / 178
Gini index (income distribution)	39.2
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	40	US	12
Hong Kong	7	China	8
Belgium	6	Germany	7
India	4	Switzerland	7

Main export products (%)	
Polished diamonds (gross)	25
Chemicals (excl refining)	27
Electronic comm., medical & scientific eq.	15
Electronic components & computers	8
Main import products (%)	
Fuel	18
Diamonds (gross)	14
Machinery & equipment	10
Chemicals & products (excl refining)	7
Openness of the economy	
Export value of G&S (% of GDP)	37
Import value of G&S (% of GDP)	35
Inward FDI (% of GDP)	0.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

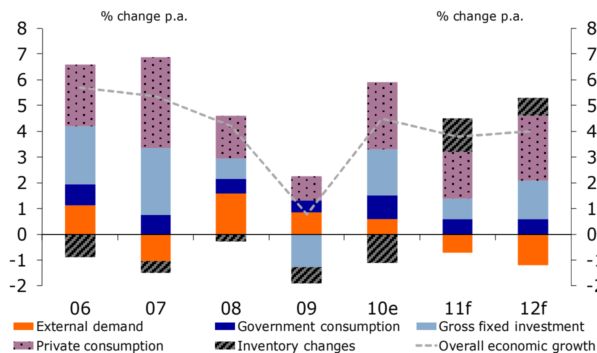
Economic structure and growth

Israel has a technologically advanced market economy with substantial, though diminishing, government participation. It depends on imports of crude oil, grains, raw materials, and military equipment. Due to limited natural resources (apart from new finds of huge gas reserves and some potash), Israel has intensively developed its agricultural and industrial sectors over the past 20 years. Its nominal GDP of USD 217bn is comparable to that of Egypt, which has more than ten times as many inhabitants. The economy is open and flexible, reflected in exports of some 40% of GDP, which are significantly oriented towards advanced economies. Israel imports substantial quantities of grain, but is largely self-sufficient in other agricultural products. Cut diamonds, high-technology equipment and agricultural products (fruits and vegetables) are the leading exports. Israel spends a higher proportion of its GDP on civilian research and development than any other country in the world. The high-tech nature of the economy is to a large extent driven by military security needs but has significant spill-over effects for civilian industrial applications. The local workforce is highly educated and public spending on education is not only high but also above the OECD average. Despite concerns about the quality of the education system, the high level of human capital is one of Israel's strongest points.

Only since August 2010, Israel is a member of the OECD, in recognition of its high stage of social and economic development level. If for all countries oil-and gas incomes are excluded, the 7.4m inhabitants have on average the highest GDP per head in the MENA region. Per capita consumption was estimated at USD 15,000 in 2009 (or 55% of per capita GDP), around ten times the Egyptian level and more comparable to some of southern EU countries, and corrected for price differences,

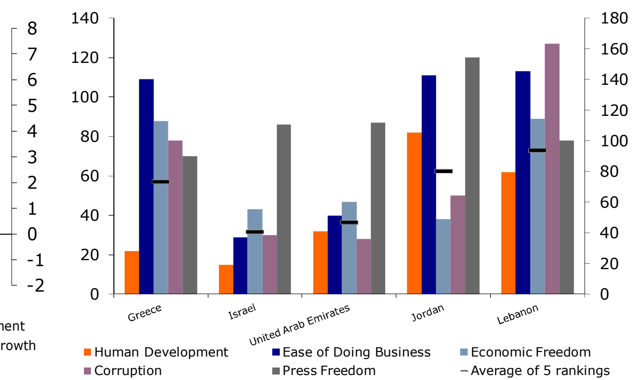
real consumption is still five times that of its neighbouring countries. Over the past decade, strong economic growth averaging around 4 percent, low or modest inflation in the 1 to 5% percent range, falling unemployment, rising private-sector wages and the wealth effects of rising house and stock market prices further increased material wellbeing. Income and wealth characteristics of many Israelis may approach those of the more advanced industrialized nations within the next decade. However, infrastructure quality indicators rank Israel almost as low as 50 out of 54 industrial and developed countries. The IMF even warned that 'an anti-investment bias' may hamper long term growth potential. Adequate planning and (in some cases decade-) long and costly delays should help in improving the performance of water, energy and transport systems. Israel's very open and financially highly integrated economy was expected to suffer dearly from the global financial crisis of 2008-2009. The crisis caused sharp falls in global demand for durable consumption and investment goods and to running down of inventories, lower commodity (oil) prices and capital flows seeking "safe havens." On each of these counts, Israel was well positioned to withstand the shocks: strong supervision shielded its banks; durable and investment goods are not Israel's strong sectors and as a large net energy importer, the unit costs of imports decreased by 10%, while export prices fell by only 2%. Moreover, the worst of the global shock was relatively brief. For these reasons, Israel unexpectedly became a safe-haven for investors, notably its own residents were frightened by the financial risks of investing abroad. As a result, real growth recovered remarkably fast in 2010 to return to its previous level of around 4% pa (see chart 1).

Chart 1: Growth performance



Source: EIU

Chart 2: Social and governance indicators



Source: EIU (lower rank indicates a better position)

According to a recent IMF study, financial and especially banking supervisory structures were, by global pre-crisis standards, highly activist and effective. The financial crisis strongly hit the non-banks and the very large corporate bond markets, but the banking system, dominated by five banks, gained rather than lost strength. The capital adequacy ratios (by mid-2010 at 13.6%) are rising, while non-performing loans ratios were down to 1.3% of gross loans in 2010 from 2.6% in 2003. Household debt, including for residences, total just 40% of GDP and loan to value ratios remained moderate or low by international standards. With deposits exceeding loans, individual banks are highly liquid and well-positioned to comply with upcoming Basel III capital requirements, even if corporate credit deteriorates and house price increases are reversed. Another recent IMF analysis, using market data such as CDS spreads and put option prices and balance sheet information, concludes that also the banking system as whole is robust. Expected losses in the banks' portfolios (with total assets amounting to 140% of GDP), as implicitly perceived by financial markets, are low relative to GDP. Moreover, there is no risk premium in the price for bank equity over that for banks debt. This indicates an implicit 100% guarantee by the Israeli government for systemic bank losses, which should be valued -on average, with 95% confidence and through the business cycle- at 14 bp only.

Political and social situation

The ongoing political upheavals in the surrounding Arab countries pose new threats to Israel's security, particularly if Islamist movements were to gain stronger political positions in Egypt and Jordan. Israel has long claimed to be the only democratic state in the region and earned credit for this. At the same time this democratic enclave maintained close relatively friendly ties with regional Arab autocrats, that are now ousted through mass protests. Israel has always expressed anxiety over possible Iran-inspired Islamist influences in its neighbors. But –albeit belatedly- the US, Israel's almost unconditional friend, has publicly supported democratic changes in the Arab countries and indicated there is no evidence of active Iranian involvement in the upheavals.
So far Israel has escaped international sanctions against its ongoing disrespect of UN resolutions and a negative opinion of the International Court of Justice concerning occupation, colonization and de facto changing of 1967-borders with the Palestine territories (West Bank and Gaza). Virtually all countries in the world support the two-state Israel and Palestine solution, and another attempt of direct peace talks with the Palestine Authority started in 2010, till now without perspective. On the Israeli side, the hard-line foreign minister Lieberman recently proposed the establishment of a new Palestinian state within 'provisional' borders, covering less than 50% of the present West Bank. There is little chance of this plan ever to be taken seriously.
Internally, given the fractious nature of coalition politics in Israel, the political landscape can easily change. Thirteen parties are represented in the Knesset (parliament) and six in the government, led by the conservative Likud party. After the recent withdrawal of the weak Labor Party, the government is supported by 66 (was 74) of the 120 delegates. The coalition consists of strong and stubborn personalities with little ideological common ground. A number of irreconcilable territorial and religious issues (Jewish nationality, the fence on Palestine territory, Jewish settlements on the West Bank) could easily lead to a new political departures. Early Knesset elections (ultimately due in 2013) should not come as a surprise.
Also more profane issues trouble the country. In many respects, Israel is a multi-cultural society, with almost 50% of the population of the "Greater Israel" (including Gaza and the West Bank) area of Palestinian background. Even in Israel proper 20% of the population is Palestinian. Some Jewish immigrants, like those of the Russian wave- are notably slow to integrate in society. The ultra-conservative Haredim community (Jewish, but partly anti-Israel; comprising 10% or the population) has demographically and in terms of military service, education, income and labor market participation more in common with the discriminated and alienated Israeli Palestinians, than with the secularized still heterogeneous melting pot of mainstream 'Jews from everywhere'. Israeli economists and social scientists have pointed to this demographic time bomb as the integration of these two large minorities in society is doubtful. But little can be done to reduce tensions, as successive governments, including the present, is dependent on Haredim.
Despite the military, political and social bombs in waiting within and just over the borders, Israel ranks relatively high in terms of overall stage of social development, legal system, civil liberties and economic freedom as chart 2 testifies.
Relationships are still good with the EU and its strong friend US, resulting in favorable trade agreements. But with the Arab Spring drawing global sympathetic attention, international support for Israel's Palestine policies is declining fast. This could lead to slower progress on EU association agreements and less automatic military co-operation with the US. Formal peace with direct neighbors hardly led to economic ties, although Israel is still highly dependent on gas imported from Egypt. Massive offshore gas fields (good for 50 years of Israel's energy consumption) are discovered could technically be operational within years. Regrettably they are in non-demarcated waters close to Lebanon, with which Israel is formally still at war. Geographically a little farther, Iran with its nuclear ambitions is still felt as a major external danger to Israel's existence.

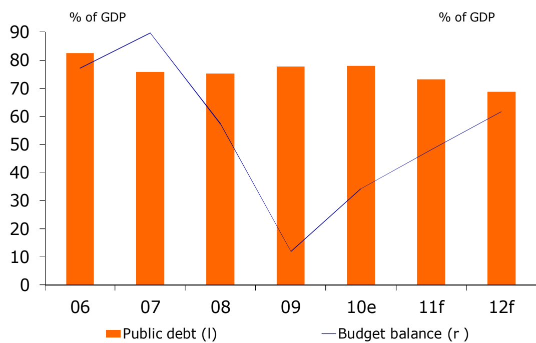
Economic policy

Israel's economic performance benefits from the broad political consensus on macroeconomic policy: fiscal discipline, price and exchange rate stability, encouragement of the private sector and deregulation. This is most likely to remain actual policy for the coming years.

An adequate monetary and fiscal policy response to the external downturn in 2008 and 2009 allowed Israel to pass through the global recession relatively smoothly. The textbook automatic fiscal stimulus (lower tax revenues, higher social expenditures) worked as intended, but led to a fiscal deficit of almost 5% of GDP in 2009 (see chart 3). When economic growth recovered in 2010, the budget deficit was reduced again, but not enough to reduce the debt/GDP ratio. More structurally and long-term, in 2010 new fiscal rules were adopted that cap the growth in spending by linking it to the formally targeted public debt/GDP ratio of 60%. This will impact central government deficits, which have by law to be reduced to 1% of GDP in 2014. Given the present debt ratio of around 75%, real public spending growth is maximized at around 2.7% per annum for the next two years, below the projected growth of real GDP of around 4%, explaining the projected lowering of the debt/GDP ratio. Given the continuing external and domestic security concerns, defence items escape the spending cuts. Social and public infrastructure expenditures will thus likely bear the brunt of the spending reductions.

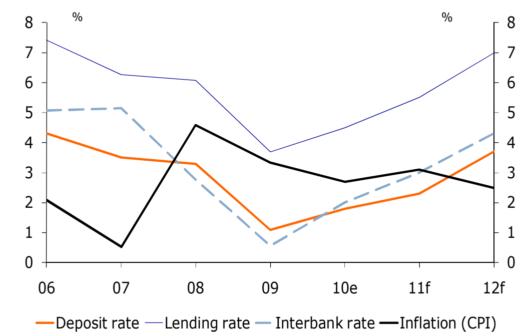
Exploitation of the recently found offshore gas fields will –if nationalized or substantially taxed and subject to some sort of border settlement with Lebanon- assist in attaining the long-term debt target. Large volumes of gas may start to flow in 2014 for domestic uses and for exports. If so, net public debt could evaporate within a decade. It is recommended to establish a long-term sovereign wealth fund, which will invest the remaining revenues to spread the gas benefits over future generations. An asset fund under control of the authorities could also provide at least some cover for the large implicit government guarantees to banks' depositors awarded to the banking system. The easy alternative, immediate spending of the windfall gas revenues, risks domestic inflation and higher interest rates which will lead to upward real effective exchange rate pressure and will thus be detrimental to the exports of the traditional sectors ('Dutch disease').

Chart 3: Public finances



Source: EIU

Chart 4: Interest rates and inflation



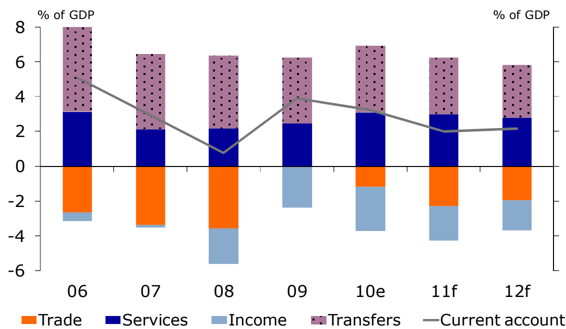
Source: EcoWin

A new bank law (2010) specifies price stability as the primary monetary policy objective to be attained through inflation targeting. The central bank is independent, with policies and rates determined by the Monetary Policy Committee out of reach of the government. Policy interest rates are on the increase since the end of 2009 and this helped to bring inflation back within the target range of 1% to 3% (see chart 4). With house and food prices sharply increasing, inflation may be up somewhat in 2011, but a further appreciation of the shekel could well be a major factor lowering the inflation pace, as it was in the recent past.

Exchange rate policies are currently aimed at reducing the inflow of hot money. Currently, the actual intervention on the currency markets reflects a 'managed float', while the return to a 'free floating regime' with only exceptional intervention is the stated policy aim. The recent rise in policy interest rates further stimulated undesired capital inflows and caused the real effective exchange rate of the shekel to appreciate by 15% since early 2008. Other inflow reducing measures, such as reserve requirements and taxation of capital inflows, are under consideration to complement or replace the costly monetary sterilization (mopping up of dollars converted in local shekels by the central bank). This may help to reduce the inflationary impact from the capital inflow, but undermines the credibility of the 'managed float'. As long as capital inflows are free, commercial banks are perceived as safe and the central bank combats inflation, financial markets remain tempted to regard the shekel as an easy one-way upward bet. The recent strong economic performance of Israel, the entry into the OECD, its high policy interest rate differential of around 200bp and the recent discovery of significant offshore natural gas reserves further augur that the exchange rate will remain under upward pressure. The shekel is already likely to be above its equilibrium rate as can be inferred from falling export volumes, lower shares in export markets and weak industrial investments.
Structural policies were, are and most likely remain strongly investment-promoting, without distinguishing between local and non-local capital sources. But ultimately, Israel's attractiveness to foreign investors and creditors is largely capped by the country's national security situation.

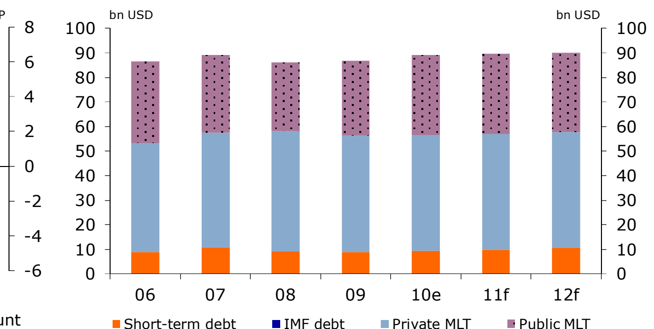
Balance of Payments
Reflecting its developed industrial base, merchandise exports comprise finished diamonds, chemicals and high-tech electronic goods (including weapons), while among imports raw fuel and diamonds dominate. Within some years the substantial net imports of fuels will be reduced significantly or even turn into net exports as the gas fields become operational and the domestic energy-infrastructure will be even more gas-based. The usual structural trade deficit may even become a surplus, once gas imports will be avoided and exports by pipe to Jordan and –in liquefied form- by ships to Europe come on stream.

Chart 5: Current account



Source: EIU

Chart 6 : Foreign debt composition



Source: EIU

Chart 5 shows that Israel's sizable trade deficits fluctuate around an average of 3% of GDP. Also in deficits, at an average of 2% of GDP, are the net incomes, reflecting remuneration for net foreign capital used (interest, dividend and profits). These outflows are more than covered by the very large transfer payments inflows of 4% of GDP from the extensive Jewish Diaspora abroad and net services revenues (tourism, business services and software) of 3% of GDP. The current account

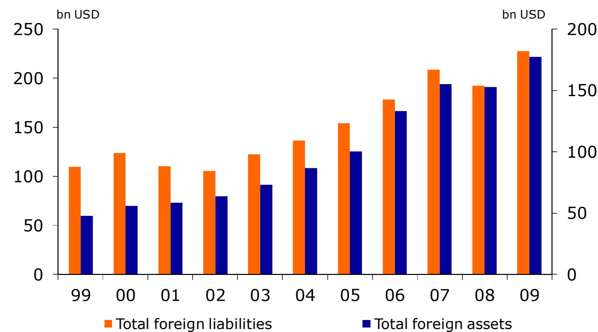
balance is structurally in surplus of around 2-3% of GDP and could increase to 4-5% reflecting the windfall revenues related to avoiding gas imports, or starting gas exports.

As Israel's capital market is free and largely integrated in the global financial markets, capital flows are volatile and thus less predictable. This holds in particular portfolio inflows, which on a net basis ranged between 0.5% and 6% of GDP over the past five years. More importantly but equally volatile are gross inflows of FDI amounting to 11% of GDP in 2006, but down to barely positive at 0.5% of GDP in 2010. Net annual foreign debt flows fluctuate between net increase of 6% of GDP (USD 9.1bn) in 2006 to a net debt repayments of 2% of GDP (USD 4.4bn) in 2008.
Remarkable is the net 'other' capital inflows, which in the years of global financial crisis (2008 and 2009) amounted to almost 18% of GDP. This inflowing capital in search of a safe haven almost fully explains the more than doubling of the foreign exchange reserves to USD 70bn over the past four years.

External position

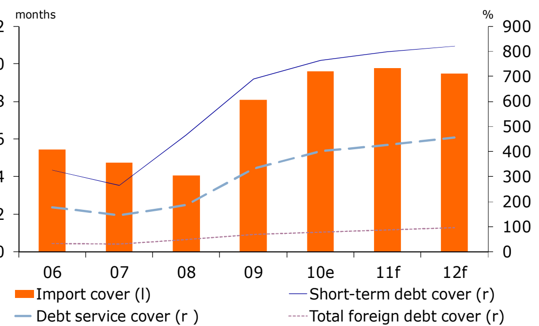
Over the past five years, Israel's total foreign debt remained nominally almost stable at around USD 85bn. Its relative level is declining from around 60% of GDP and 100% of export revenues to 40% and 90% respectively. Some 90% of total debt is medium and long term with annual repayments only 5% of actual debt outstanding. This reflects a very favorable average maturity of no less than 20 year. But at a cost; interest payments are high at around 7% of outstanding debt and cost about 5% of export revenues. There were and are no interest or principal arrears of any government or government–guaranteed debt.

Chart 7: Foreign debt



Source: EIU

Chart 8: External liquidity



Source: Covers offered by official FX-reserves, EIU

With realized structural current account surpluses since 2002, Israel reduced its net debtor position from 45% of GDP at the start of the millennium to a mere 3% by the end of 2009 (see chart 7). With the persisting external current account surplus in 2010, Israel is now likely to have attained a net creditor status, although value changes may distort this rough calculation.
With external current account surpluses and capital flowing in, all of the country's liquidity indicators show increasingly comfortable levels as chart 8 demonstrates.

Israel							
Nominal GDP (in bn US$)	146.2	168.0	202.3	195.4	217.1	241.9	255.6
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	5.7	5.4	4.2	0.8	4.5	3.8	4.0
Consumer prices (average % change pa)	2.1	0.5	4.6	3.3	2.7	3.1	2.5
Current account balance (% of GDP)	5.1	2.9	0.8	3.9	3.2	2.0	2.2
Total foreign exchange reserves (mln USD)	29153	28519	42513	60611	70920	78720	87610
Economic growth							
GDP (% real change pa)	5.7	5.4	4.2	0.8	4.5	3.8	4.0
Gross fixed investment (% real change pa)	13.6	14.6	4.1	-6.5	9.9	4.5	7.9
Private consumption (real % change pa)	4.3	6.4	3.0	1.7	4.7	3.2	4.5
Government consumption (% real change pa)	3.1	3.1	2.6	2.5	3.7	2.5	2.5
Exports of G&S (% real change pa)	5.9	9.3	5.9	-11.7	12.6	6.3	10.2
Imports of G&S (% real change pa)	3.2	11.9	2.3	-14.1	11.9	8.5	13.6
Economic policy							
Budget balance (% of GDP)	-0.8	0.0	-2.2	-5.2	-3.7	-2.8	-1.9
Public debt (% of GDP)	83	76	75	78	78	73	69
Money market interest rate (%)	5.1	5.2	2.8	0.6	2.0	3.0	4.3
M2 growth (% change pa)	5	15	10	18	5	10	15
Consumer prices (average % change pa)	2.1	0.5	4.6	3.3	2.7	3.1	2.5
Exchange rate LCU to USD (average)	4.5	4.1	3.6	3.9	3.7	3.6	3.7
Recorded unemployment (%)	8.4	7.3	6.1	7.5	6.7	6.5	6.1
Balance of payments (mln USD)							
Current account balance	7434	4923	1554	7592	6992	4830	5560
Trade balance	-3837	-5684	-7239	-95	-2570	-5490	-5000
Export value of goods	43319	50286	57161	45898	55361	61880	72710
Import value of goods	47156	55970	64400	45993	57931	67370	77710
Services balance	4569	3568	4396	4844	6723	7240	7110
Income balance	-740	-217	-4084	-4559	-5452	-4830	-4350
Transfer balance	7442	7256	8481	7402	8292	7910	7790
Net direct investment flows	-166	194	3667	2722	-6400	300	1300
Net portfolio investment flows	-9587	-2965	-990	-5260	-2955	-70	-1460
Net debt flows	9088	1730	-4429	1020	2905	960	1040
Other capital flows (negative is flight)	-5674	-4516	14193	12024	9767	1780	2450
Change in international reserves	1094	-635	13995	18098	10309	7800	8890
External position (mln USD)							
Total foreign debt	86531	89117	86083	86775	89234	89620	90150
Short-term debt	8959	10745	9119	8798	9296	9860	10670
Total debt service due, incl. short-term debt	16332	19527	22616	18231	17625	18510	19260
Total foreign exchange reserves	29153	28519	42513	60611	70920	78720	87610
International investment position	-11945	-14899	-1454	-5956	n.a.	n.a.	n.a.
Total assets	166445	193836	190857	221701	n.a.	n.a.	n.a.
Total liabilities	178390	208735	192311	227657	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-2.6	-3.4	-3.6	0.0	-1.2	-2.3	-2.0
Current account balance (% of GDP)	5.1	2.9	0.8	3.9	3.2	2.0	2.2
Inward FDI (% of GDP)	10.5	5.2	5.4	2.0	0.5	1.4	2.5
Foreign debt (% of GDP)	59	53	43	44	41	37	35
Foreign debt (% of XGSIT)	109	98	88	106	94	85	76
International investment position (% of GDP)	-8.2	-8.9	-0.7	-3.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	21	21	23	22	19	18	16
Interest service ratio incl. arrears (% of XGSIT)	7	7	6	6	5	5	5
FX-reserves import cover (months)	5.4	4.8	4.1	8.1	9.6	9.8	9.5
FX-reserves debt service cover (%)	179	146	188	332	402	425	455
Liquidity ratio	161	155	141	169	175	175	175

Source: EIU 20110308

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