Rabobank

Country report **ISRAEL**

Summary

Contagion from the Arab Spring hit Israel when massive street protests ensued in July 2011, and social unrest could flare up again if the protesters' demands are not met. Geopolitical tensions have risen markedly in the recent twelve months; rhetoric on joint US/Israeli air strikes against Iran has increased, a spat with Turkey following an Israeli attack on a Turkish flotilla has deteriorated relations between both countries and a territorial conflict with Lebanon over maritime gas fields ensued. Meanwhile, the conflicts with the Palestinians and Hamas also remain. Israel's modern, high-tech, open and service based economy is expected to slow from 4.8% in 2011 to 2% in 2012. The slowdown is for the largest part attributable to lower demand from the tepidly recovering US economy and the troubled eurozone, Israel's largest trading partners.

Things to watch:

- Government efforts to meet protesters' demands
- Risk of US/Israeli strikes on Iran and retaliation
- Recovery of US and eurozone economies

Author: **Ashwin Matabadal**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-61601
A.R.K.Matabadal@rn.rabobank.nl

Israel

National facts		
Type of government	Parliamentary democracy	
Capital	Jerusalem	
Surface area (thousand sq km)	22	
Population (millions)	7.6	
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		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	243	0.35
Nominal GDP at PPP	234	0.30
Export value of goods and services	89	0.41
IMF quotum (in mln SDR)	1061	0.49
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.8	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	31244	290
Nominal GDP per head at PPP	30156	244
Real GDP per head	22169	273

Social and governance indicators	rank / total
Human Development Index (rank)	17 / 187
Ease of doing business (rank)	34 / 183
Economic freedom index (rank)	48 / 179
Corruption perceptions index (rank)	36 / 183
Press freedom index (rank)	92 / 178
Gini index (income distribution)	39
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	36	US	11
Hong Kong	8	China	8
Belgium	6	Germany	6
India	6	Switzerland	6

Main export products (%)	
Chemicals & chemical products (excl refining)	26
Polished diamonds (gross)	17
Communication, medical & scientific equipment	14
Electronic components & computers	8
Main import products (%)	
Fuel	17
Diamonds (gross)	11
Machinery & equipment	8
Chemicals & chemical products (excl refining)	6
Openness of the economy	
Export value of G&S (% of GDP)	37
Import value of G&S (% of GDP)	37
Inward FDI (% of GDP)	2.9

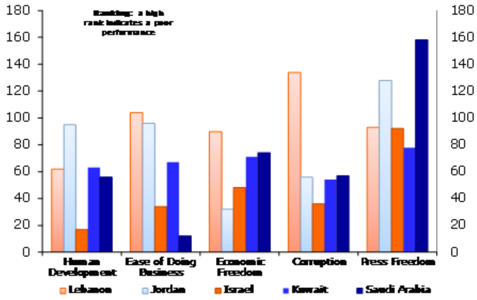
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Israel is a technologically advanced market economy with substantial, though diminishing, government participation. The country is dependent 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 243bn is comparable to that of Egypt, which has more than ten times as many inhabitants. The economy is open and flexible, reflected in the sum of import and export of goods and services amounting to 74% of GDP. Israel is significantly oriented towards advanced economies. The US in particular, is an important partner, as it is Israel's largest export market with 36% of total exports and is a significant source of investment. 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.

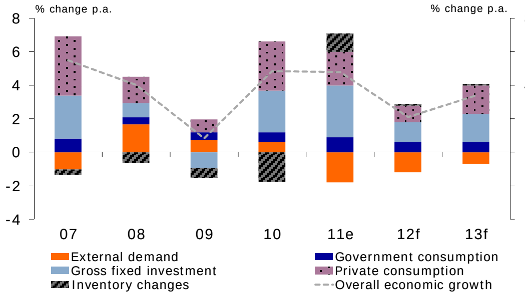
Israel spends a higher proportion of its GDP on private research and development than any other country in the world. The high-tech nature of the economy is to a large extent driven by military security needs, but has significant spill-over effects for civilian industrial applications. The local workforce is highly educated and public spending on education is not just high but even above the OECD average – although it has decreased in the past years as the drive to invest in education diminished with the influx of well-educated Russian Jews. Despite concerns about the quality of the education system, the high level of human capital is one of Israel's strongest points. This is

Figure 1: Social indicators



Source: EIU

Figure 2: Growth performance



Source: EIU

reflected in the high ranking of 17th out of 187 countries in the Human Development Index of the UN, scoring even higher than developed countries such as France, Spain, Finland and the UK. Since August 2010, Israel is a member of the OECD, in recognition of its advanced stage of social and economic development. Excluding the oil- and gas-income countries, the 7.6m inhabitants have on average the highest GDP per head in the MENA region. Nominal GDP per capita was estimated at USD 31,244 in 2011. Even so, real wages have stagnated over the past decade and the poverty rate is an ongoing concern, resulting in social unrest in the past year (more on that below).

The country's operational environment is generally favorable, although land issues and the government may occasionally interfere with the activities of foreign firms. The World Bank ranked Israel 29 out of 183 economies in its 2011 Ease of Doing Business index. There are few restrictions on foreign investors, with the exception of certain sectors that are closed on national security grounds, such as communications and broadcasting. Although present, corruption is not considered to be significant enough to actively hamper business activity, with Transparency International ranking Israel 30 out of 178 countries in its 2010 Corruption Perceptions Index.

The banking sector in Israel is dominated by five large banks, which are, according to a recent IMF banking sector risk assessment, in sound shape. Capitalization ratios have been rising compared to last year, although much of the increase has taken the form of Tier 2 capital. Non-performing loans are low and well-provisioned.

Economic growth had rebounded quickly after dipping to 0.8% in 2009 due to the global financial crisis. After growing a robust 4.8% in 2010 and an estimated 4.8% in 2011 as well, growth is expected to slow in 2012 to little over 2%. The main drag for the export dependent economy is the European slowdown, as a result of the lingering peripheral debt crisis, and the slowly improving US economy. Economic growth in 2012 is expected to be led by private consumption and gross fixed investment.

Political and social situation

Israel's coalition politics are highly fractious by nature and repeatedly these coalitions are prone to indecision and break down regularly. This has often resulted in an inability of the government to push through crucial domestic issues. Currently, thirteen parties are represented in the Knesset (parliament) and six in the government, led by the conservative Likud party. The present coalition consists of strong and stubborn personalities with little common ideological ground. A number of irreconcilable religious and territorial issues such Jewish nationality, the fence on Palestine territory and Jewish settlements on the West Bank could easily lead to new political departures. As such, Prime Minister Netanyahu continues to face a tough balancing act to keep his government together.

The government faced a burst of domestic social tensions last year, as contagion from the Arab Spring protests hit the country in July. The protests began rather spontaneously, when a few students pitched tents in one of Tel Aviv's main streets. Initially, the protests were dismissed as a kind of summer camp for spoiled middle-class students demanding cheap enough housing for them to live in hip Tel Aviv. However, their campsite attracted thousands of visitors, overwhelmingly supportive and of all ages, economic standing and political affiliation. The resulting large-scale rally and march held in Tel Aviv on July 23rd confirmed this was a protest with deep roots. Simmering socio-economic tensions had burst forth from the academic forums to the streets. However, the mass protests faded out over time, as the economy was growing robustly and unemployment was at records lows in 2011. Furthermore, the government took measures to curb the rising housing prices. Nonetheless, if the economy slows and unemployment rises, a resurgence of protests is not unlikely – although the government is known to cleverly use external 'enemies' to divert public attention.

Further domestic tensions that the country faces, are with the Hamas, the Palestinian Sunni Islamic political party that governs the Gaza strip. Hamas also has a military wing, the Izzad-Din al-Qassam brigades. Israel announced a unilateral ceasefire on 17 January 2009 ending its war in the Gaza Strip. The ceasefire was followed shortly by Hamas's own declaration of intent to cease hostilities; however, the truce has remained tenuous and there have been sporadic outbursts of violence. On 7 April 2011, a school bus in southern Israel was hit by a rocket fired from Gaza by the military wing of Hamas, sparking the heaviest bombing of the Gaza Strip since the ceasefire in 2009. The current arrangements in Gaza leave the issues at the heart of the conflict largely unresolved, especially since Hamas retains the capacity to fire rockets deep into Israel.

The government also has to deal with ethnically related social tensions, since Israel is a multi-cultural society, with almost 50% of the population of the "Greater Israel" area (i.e. including Gaza and the West Bank) of Palestinian background. Even in Israel proper, 20% of the population is Palestinian. Moreover, some Jewish immigrants, like those of the Russian wave, are notably slow to integrate in society. The Israeli population further consists of the ultra-conservative Haredim community, which is Jewish, but partly anti-Israel and comprises of 10% of the population. The group has socio-economically 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 large minorities in society is doubtful.

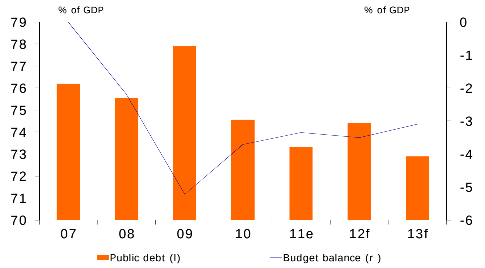
The long-standing issue with the Palestinians is not only a significant source of tension in Israel, but also affects Israel's standings internationally. So far Israel has escaped international sanctions in response to its ongoing disrespect of UN resolutions and a negative opinion of the International 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 started in 2010. In these talks, the US attempted to bring the Netanyahu government and the Palestine Authority together, but these failed over Israel's refusal to extend a moratorium on the building of settlements in the West Bank and Jerusalem. There is little prospect for successful talks in the near term.

Still, on the international front, relationships are good with the EU and its strong friend US. Israel is an important factor in the US government's policy on the Middle East, and the US Congress has placed importance of maintaining a close and supportive relationship. Since 1985, Israel has been one of the largest recipients of economic and military assistance from the US, and this assistance has proven vital for Israel in the past decades.

Outside the US and EU, international tensions have increased further in the past year. Rhetoric over joint Israeli/US strikes against Iran has increased, as Iran continues with its controversial nuclear program. Israel has always been fearful of Iran, not only because of its nuclear ambitions but also because of possible Iran-inspired Islamist influences in its neighbors. While we expect no escalation to the extent of actual missile strikes, tensions will remain elevated in the near term. Tensions with Turkey also escalated after a publication by the UN was leaked on September 2nd, 2011 about Israel's attack on a flotilla bringing aid to Gaza in May 2010. During the attack Israeli commandos killed eight Turks and one Turkish-American. The UN report upheld the legality of Israel's blockade of Gaza, and hence it's boarding the flotilla outside territorial waters, but found Israel's methods "excessive and unreasonable". In response, Turkey has formally expelled the Israeli ambassador and suspended military links. Furthermore, a maritime border dispute between Israel and Lebanon ensued last year. Israel discovered two large gas fields, one of the world's largest finds in almost a decade, just off its coast in the Mediterranean Sea. However, tensions with Lebanon rose after that country was reported to have begun its own undersea oil exploration and Iran offered its help. No maritime borders have been demarcated yet and the UN is asked to mediate.

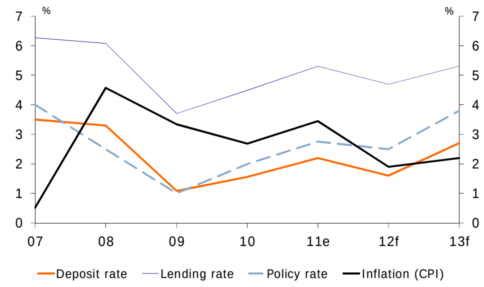
In a final word on international standings, relations with Egypt have soured in April 2011, as the Egyptian gas company EGAS has cut gas deliveries to Israel, claiming that Israel has not made payments in over four months. However, the buyer on the Israeli side, AMPAL, says EGAS has violated the contract. While EGAS states this was a purely commercial decision, it seems more likely to have been motivated by populist pressures, including anti-corruption sentiments. Moreover, a former Israeli president had brokered a very favorable gas deal in 2005, which has frustrated the Egyptian population, and the gas pipeline has been attacked 14 times since then. The economic impact is yet unknown, but around 40% of Israel's gas imports comes from Egypt, which is used for the electricity generation. In any case, these events will cast a shadow over the relationship between both countries.

Figure 3: Public finances



Source: EIU

Figure 4: Inflation and interest rates



Source: EIU

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. 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. The budget deficit was 3.3% of GDP in 2011 and forecast at 3.5% of GDP in 2012; no significant change.

In response to the social unrest, the government has reversed certain tax reductions. It plans to increase corporate tax rates and personal income tax rates of individuals earning over USD 130,000 a year. Furthermore, the government has taken measures aimed at cooling the housing market. These include additional capital requirements for new housing loans, increased loan-loss provisions for loans with high loan-to-value, increases in tax rates on purchases of apartments, removal of barriers in land marketing and planning and a reduction of taxes on land sales.

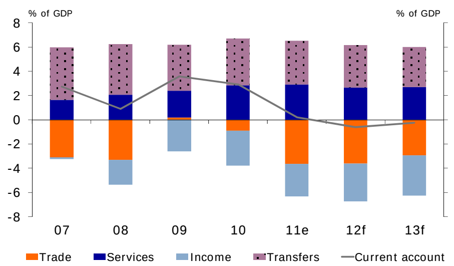
Achieving the long-term public debt target of 60% of GDP will be easy if Israel makes haste with the exploitation of the recently found offshore gas fields. Large volumes of gas may start to flow in 2014 for domestic uses and for exports. If so, net public debt could evaporate within a decade. It is 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. 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').

The central bank (CB) is independent, with policies and rates determined by the Monetary Policy Committee out of reach of the government. A bank law implemented in 2010 specifies price stability as the primary monetary policy objective to be attained through inflation targeting. In 2011, the CB pursued an aggressive path of policy rate hikes to rein in inflation, with the benchmark policy rate peaking at 3.25%. Since the peak of 4.3% yoy in March 2011, inflation has been on a steady decline and recorded a low 1.9% in March 2012. Early this year, the CB has loosened monetary policy as the global downturn persists and lowered the policy rates to 2.5%. Depending on inflation developments, the monetary policy will possibly be tightened again in 2013.

Balance of Payments

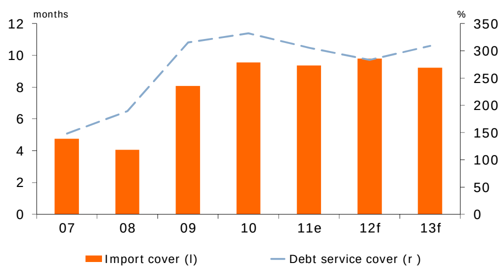
Reflecting its developed industrial base, merchandise exports comprise finished diamonds, chemicals and high-tech electronic goods (including weapons), while among imports raw fuel and diamonds dominate. Within some years the substantial net imports of fuels will be reduced significantly or even turn into net exports as the gas fields become operational and the domestic

Figure 5: Current account



Source: EIU

Figure 6: External liquidity



Source: EIU

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.

Figure 5 shows that Israel's trade deficits have fluctuated between 0-3% of GDP in the past five years. Also in deficit, at an average of 2% of GDP in the past five years, is the income balance, reflecting remuneration for net foreign capital used (interest, dividend and profits). These outflows are more than covered by the very large transfer payments inflows, averaging 4% of GDP in the past five years 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 0-3% of GDP, but this could turn into a small deficit in 2012 if global oil prices remain high. However, this could reverse to a surplus of 4-5% easily in the near term when the windfall revenues related to having to import less gas or starting gas exports from the new gas fields come in.

As Israel's capital market is free and largely integrated in the global financial markets, capital flows are volatile and thus less predictable. Remarkable is the net 'other' capital inflows, which in the years of global financial crisis of 2008 and 2009 amounted to almost 18% of GDP. While the exact composition of these 'other' capital inflows remains unexplained, due to a lack of data, but it is likely to be capital inflows in search of a safe haven. This inflowing capital in search of a safe haven almost fully explains the more than doubling of the FX-reserves to USD 75bn at end-2011 since end-2007.

External position

Over the past three years, Israel's total foreign debt increased nominally to around USD 110bn, but relatively it has been rather stable, fluctuating between 44% and 49% of GDP. It is forecast at 48% of GDP for 2012. Some 90% of total debt is medium and long term with annual repayments, which 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 are no interest or principal arrears of any government or government–guaranteed debt. The liquidity position of Israel is very healthy, as FX-reserves cover imports by 9 months and debt service by 306%, both very sound levels.

Israel

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	5.5	4.0	0.8	4.8	4.8	2.1	3.4
Consumer prices (average % change pa)	0.5	4.6	3.3	2.7	3.5	1.9	2.2
Current account balance (% of GDP)	2.7	0.9	3.6	2.9	0.2	-0.6	-0.3
Total foreign exchange reserves (mln USD)	28519	42513	60611	70907	74874	73950	78150
Economic growth							
GDP (% real change pa)	5.5	4.0	0.8	4.8	4.8	2.1	3.4
Gross fixed investment (% real change pa)	14.5	4.4	-4.9	13.7	11.0	5.5	7.5
Private consumption (real % change pa)	6.4	2.8	1.4	5.3	3.5	1.9	3.2
Government consumption (% real change pa)	3.3	1.7	1.8	2.5	2.3	2.7	2.5
Exports of G&S (% real change pa)	9.3	6.0	-11.9	13.6	4.1	1.7	4.4
Imports of G&S (% real change pa)	11.9	2.2	-14.0	12.8	8.9	4.4	6.0
Economic policy							
Budget balance (% of GDP)	0.0	-2.2	-5.2	-3.7	-3.3	-3.5	-3.1
Public debt (% of GDP)	76	76	78	75	73	74	73
Money market interest rate (%)	5.2	2.8	0.6	0.2	0.2	0.2	1.5
M2 growth (% change pa)	15	10	18	4	9	7	10
Consumer prices (average % change pa)	0.5	4.6	3.3	2.7	3.5	1.9	2.2
Exchange rate LCU to USD (average)	4.1	3.6	3.9	3.7	3.6	3.9	4.0
Recorded unemployment (%)	7.3	6.1	7.5	6.7	5.8	6.7	6.8
Balance of payments (mln USD)							
Current account balance	4559	1830	6977	6319	456	-1420	-630
Trade balance	-5178	-6685	341	-1948	-8844	-8440	-7150
Export value of goods	50792	57713	46334	56094	62899	63560	68180
Import value of goods	55970	64398	45993	58042	71743	72000	75330
Services balance	2741	4149	4322	6174	7035	6180	6500
Income balance	-260	-4115	-5088	-6316	-6518	-7330	-8050
Transfer balance	7256	8481	7402	8409	8783	8170	8070
Net direct investment flows	194	3665	2743	-2807	2900	1100	2500
Net portfolio investment flows	-2271	-2483	-7979	-6769	-557	-3660	-510
Net debt flows	1986	-2409	5225	13250	3445	3220	-700
Other capital flows (negative is flight)	-5102	13392	11133	303	-2277	-170	3540
Change in international reserves	-635	13995	18098	10296	3967	-930	4200
External position (mln USD)							
Total foreign debt	89387	88358	93249	106041	110498	112510	111260
Short-term debt	10745	9285	10573	12027	13529	12860	12690
Total debt service due, incl. short-term debt	19243	22507	19232	21352	24497	26100	25260
Total foreign exchange reserves	28519	42513	60611	70907	74874	73950	78150
International investment position	-17058	-3801	-6451	-640	n.a.	n.a.	n.a.
Total assets	190687	187969	220428	250590	n.a.	n.a.	n.a.
Total liabilities	207745	191770	226879	251230	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-3.1	-3.3	0.2	-0.9	-3.6	-3.6	-3.0
Current account balance (% of GDP)	2.7	0.9	3.6	2.9	0.2	-0.6	-0.3
Inward FDI (% of GDP)	5.3	5.4	2.3	2.4	2.9	2.7	3.8
Foreign debt (% of GDP)	53	44	48	49	46	48	46
Foreign debt (% of XGSIT)	99	90	114	111	104	107	100
International investment position (% of GDP)	-10.2	-1.9	-3.3	-0.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	21	23	23	22	23	25	23
Interest service ratio incl. arrears (% of XGSIT)	7	6	7	6	6	6	6
FX-reserves import cover (months)	4.8	4.1	8.1	9.6	9.4	9.8	9.2
FX-reserves debt service cover (%)	148	189	315	332	306	283	309
Liquidity ratio	155	141	167	168	158	158	158

Source: EIU