Research Update:

Israel Long-Term Ratings Lowered To 'A' From 'A+' On Heightened Security Risk; Outlook Negative

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Overview

- We see an increasing likelihood that Israel's conflict with Hezbollah, given the recent escalation of fighting, becomes more protracted and intensifies, posing security risks for Israel.
- We now consider that military activity in Gaza and an upsurge in fighting across Israel's northern border--including a ground incursion into Lebanon--could persist into 2025, with risks of retaliation against Israel. The latter in particular has been highlighted by a missile attack on Israel by Iran at the beginning of October.
- Consequently, we expect a delayed economic recovery in Israel and have revised down our real growth forecasts to 0% in 2024 and 2.2% in 2025, alongside widening fiscal deficits both in the short- and medium-term as defense-related spending increases further.
- We lowered our long-term sovereign credit ratings on Israel to 'A' from 'A+'. The outlook on the long-term ratings is negative.

Rating Action

On Oct. 1, 2024, S&P Global Ratings lowered its long-term foreign and local currency sovereign credit ratings on Israel to 'A' from 'A+'. The outlook on the long-term ratings is negative. We affirmed the short-term ratings at 'A-1'. At the same time, we revised the transfer and convertibility assessment to 'AA-' from 'AA'.

As sovereign ratings (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on Israel are subject to certain publication restrictions set out in article 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2024 EMEA Sovereign, Regional, And Local Government Rating Publication Dates: Midyear Update," published July 3, 2024). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation is the significant increase of geopolitical and security risks around Israel. The next scheduled ratings review for Israel is on Nov. 8, 2024.

Outlook

The negative outlook reflects the risks to Israel's growth, public finances, and balance of payments from the intensifying conflict against Hezbollah in Lebanon, including direct security threats in case of retaliatory rocket attacks against Israel. The negative outlook also reflects the risk of a more direct war with Iran, although this is not in our current base case.

Downside scenario

We could lower the ratings on Israel in the next 24 months if the military conflicts become a bigger-than-anticipated detriment to Israel's economic growth, fiscal position, and balance of payments. This could be the case, for example, if the ongoing conflicts continue to spread, raising the risks of retaliatory attacks against Israel, or if the prospect of a wider regional war directly involving Iran increases.

Upside scenario

We could revise the outlook to stable if we observed a reduced likelihood of military escalation and the broader security risks moderated.

Rationale

The downgrade reflects the fallout on Israel's economy and public finances from a worsening conflict with Hezbollah in Lebanon, including possible security threats in case of retaliatory rocket attacks against Israel. The latter in particular has been highlighted by a missile attack on Israel by Iran at the beginning of October. We now expect Israel's economic recovery to slow with real GDP growth of 0% in 2024 and 2.2% in 2025, from 0.5% and 5.0%, respectively, under our previous forecast. We also project that Israel will run wider fiscal deficits both in the short- and medium-term as defense-related spending increases further.

Almost a year after the Hamas assault and the ensuing war, Israel's focus appears to be on securing its northern border from the Hezbollah attacks that have continued over the last 12 months and on the safe return of Israel residents displaced from the north of the country. Israel has significantly upped attacks against Hezbollah in Lebanon since mid-September 2024, initially appearing to have engineered the detonation of communications devices purchased by Hezbollah and subsequently through a series of missile strikes in Lebanon that killed Hezbollah's leader Hassan Nasrallah and led to significant reported casualties and displacement of residents from southern Lebanon. Furthermore, over the last two days Israel launched airstrikes against Houthi targets in Yemen while Iran targeted Israel in a missile strike.

We see two near-term implications of the recent conflict escalation for Israel.

The first involves an increased risk from retaliatory rocket fire from Hezbollah, other Iran proxies in the region or Iran itself. Although Israel has an advanced air defense system, the possibility of damage on Israeli territory, including to infrastructure, remains but is difficult to quantify.

The second pertains to the broader economic impact of the recent escalation. We use the following assumptions in our updated base-case scenario for Israel:

- Continued, though likely reduced, military activity in Gaza alongside more intense fighting with Hezbollah lasting into 2025;

- Hezbollah and other Iranian proxies likely to conduct retaliatory strikes against Israel, but no sustained damage on the ground or to critical infrastructure; and
- No wider sustained regional war directly involving Iran beyond more limited retaliatory attacks.

Under these assumptions, we expect Israel's real GDP to stagnate in 2024. We anticipate that higher security threats will dampen consumer and investor confidence, while tourism, construction, and agricultural sectors will remain affected. A wider ground operation in Lebanon requiring a call-up of reservists could also constrain economic recovery in the short term.

We now expect growth of 2.2% in 2025, versus 5.0% previously. Subsequently, we expect the recovery to take hold from 2026 assuming the security situation stabilizes in the second half of 2025.

We also forecast that the current escalation in fighting will underpin an enduring increase in defense-related expenditures. This leads us to forecast a general government deficit of 9% of GDP for 2024, before it reduces to 6% of GDP in 2025. Similarly, fiscal deficits are likely to average 5% of GDP over 2026-2027. We note, however, that Israeli authorities remain committed to fiscal consolidation via a range of measures including the rationalizing of ministry spending, freezing of tax thresholds and others with the ultimate goal of stopping the rise in government debt as a percentage of GDP.

A wider Middle East conflict, involving Iran or other players opposed to Israel, is still not our baseline scenario. This is chiefly because we think Iran may avoid such escalation due the security and economic consequences this would incur. We consider that, despite the multiple escalations in the region throughout this year, including the most recent missile attack, Iran has also on several occasions demonstrated restraint and an unwillingness to take the conflict to a regional level. Iran's president, Masoud Pezeshkian, stressed an interest in diplomacy during a recent speech at the United Nations. However, we acknowledge the possibility of an accident or a miscalculation by one of the sides that could unintentionally lead to further escalation.

Despite the aforementioned risks, our ratings on Israel remain supported by several key strengths. The most important one is Israel's highly adaptable and diversified economy. Israel has historically enjoyed strong growth rates and has rebounded briskly from previous crisis. It has high per capita income levels, and we note that the economy's concentration on exports of high-tech services also provides for higher ability for some employees to work remotely, mitigating the impact of security disruptions on the domestic economy.

In addition, we expect Israel's balance of payments to remain a key ratings strength. The country has been running a current account surplus for decades, primarily supported by the fast expansion of high-value-added information and communication technology services exports. The total external services surplus has averaged 7% of GDP in the past five years. As a result, Israel has shifted into a substantial net external asset position of about 40% of GDP--one of the highest among non-commodity-exporting sovereigns--and reduced its gross external financing needs.

In 2023, the current account surplus amounted to 4.5% of GDP, broadly in line with outcomes over 2020-2022. Although the war has significantly affected Israel's appeal as a travel destination, the foreign tourism sector constitutes just 3% of Israeli current account receipts while outbound tourism has also declined notably, thus reducing the net impact on Israel's balance of payments. We expect the exports of high-value-added technology goods and services will continue uninterrupted and Israel's current account surpluses will average 3.3% of GDP through 2027.

Following a dip in October 2023, the Bank of Israel's gross international reserves have exceeded pre-war levels, reaching US$217 billion (42% of GDP) at the end of August 2024. This is a significant buffer, in our view, given that it covers 1.6x the gross external debt of the whole economy (including the public sector, banks, and the nonbank corporate sector) and affords Israel policy room to maneuver.

Key Statistics

Table 1

Israel--Selected Indicators

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Economic indicators (%)										
Nominal GDP (bil. LC)	1,347	1,425	1,417	1,591	1,773	1,884	1,940	2,032	2,185	2,316
Nominal GDP (bil. $)	375	400	412	493	528	514	522	535	583	626
GDP per capita (000s $)	42.2	44.2	44.7	52.6	55.3	52.7	52.6	52.8	56.4	59.4
Real GDP growth	4.1	3.8	(1.5)	9.9	6.4	2.0	0.0	2.2	5.0	3.5
Real GDP per capita growth	2.1	1.8	(3.2)	8.0	4.4	0.0	(2.0)	0.2	2.9	1.5
Real investment growth	7.6	3.9	(3.1)	15.4	10.8	(1.4)	(12.5)	2.7	13.5	8.0
Investment/GDP	23.9	23.7	24.2	25.7	27.3	26.1	23.1	23.2	24.8	25.6
Savings/GDP	26.9	27.1	29.0	29.6	31.2	30.5	26.7	26.5	27.9	28.6
Exports/GDP	30.0	29.3	27.6	29.2	31.6	30.6	28.6	29.0	29.6	29.5
Real exports growth	5.6	2.9	(2.4)	14.9	8.4	(1.1)	(6.5)	3.4	6.5	2.5
Unemployment rate	4.0	3.8	4.4	5.0	3.8	3.5	3.3	3.3	3.0	3.0
External indicators (%)										
Current account balance/GDP	3.0	3.4	4.9	3.9	3.9	4.4	3.6	3.3	3.2	3.0
Current account balance/CARs	8.0	9.5	14.6	11.0	10.2	11.8	10.2	9.0	8.8	8.4
CARs/GDP	37.2	36.0	33.4	35.8	38.1	37.2	35.5	36.2	36.2	35.7
Trade balance/GDP	(4.5)	(3.8)	(2.8)	(4.4)	(4.9)	(3.9)	(4.5)	(4.8)	(5.0)	(5.2)
Net FDI/GDP	4.1	2.2	4.0	1.7	2.3	1.6	1.5	1.5	2.0	2.0
Net portfolio equity inflow/GDP	(4.1)	(1.5)	(5.2)	(0.7)	1.3	0.4	(2.0)	(2.0)	(2.0)	(2.0)
Gross external financing needs/CARs plus usable reserves	66.1	65.0	60.2	58.5	57.3	57.4	55.8	54.5	55.2	55.5
Narrow net external debt/CARs	(46.6)	(51.5)	(68.7)	(66.9)	(54.6)	(73.2)	(76.3)	(74.9)	(71.5)	(70.4)
Narrow net external debt/CAPs	(50.7)	(56.9)	(80.4)	(75.2)	(60.8)	(83.0)	(85.0)	(82.4)	(78.4)	(76.9)
Net external liabilities/CARs	(98.4)	(110.2)	(135.2)	(89.8)	(80.2)	(112.7)	(124.7)	(128.9)	(128.7)	(132.4)

Table 1

Israel--Selected Indicators (cont.)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Net external liabilities/CAPs	(107.0)	(121.8)	(158.3)	(100.9)	(89.4)	(127.7)	(138.8)	(141.6)	(141.1)	(144.5)
Short-term external debt by remaining maturity/CARs	27.7	26.5	29.9	27.0	28.2	27.5	27.6	24.9	22.3	21.2
Usable reserves/CAPs (months)	10.6	10.6	12.9	13.3	14.2	13.8	14.8	14.8	13.9	13.5
Usable reserves (mil. $)	115,279	126,014	173,297	212,992	194,218	204,694	217,755	223,103	230,679	238,816
Fiscal indicators (general government; %)										
Balance/GDP	(4.4)	(4.5)	(11.4)	(5.3)	(1.8)	(6.7)	(9.0)	(6.0)	(5.0)	(5.0)
Change in net debt/GDP	3.0	3.0	9.3	2.6	0.7	4.4	9.4	6.0	4.7	5.0
Primary balance/GDP	(1.6)	(1.8)	(8.8)	(2.7)	0.6	(4.4)	(6.3)	(3.0)	(1.9)	(1.9)
Revenue/GDP	36.1	35.3	34.5	36.9	37.5	34.7	35.0	35.0	35.0	35.0
Expenditures/GDP	40.4	39.8	45.9	42.2	39.3	41.5	44.0	41.0	40.0	40.0
Interest/revenues	7.7	7.6	7.8	7.0	6.3	6.8	7.7	8.7	8.8	8.9
Debt/GDP	60.1	59.2	70.9	67.4	60.2	61.4	69.1	71.9	71.6	72.6
Debt/revenues	166.7	167.7	205.6	182.8	160.6	177.0	197.4	205.6	204.7	207.4
Net debt/GDP	58.0	57.9	67.4	62.6	56.9	58.0	65.7	68.7	68.6	69.8
Liquid assets/GDP	2.1	1.4	3.5	4.8	3.3	3.5	3.4	3.2	3.0	2.8
Monetary indicators (%)										
CPI growth	0.8	0.8	(0.6)	1.5	4.4	4.2	3.4	2.8	2.5	2.0
GDP deflator growth	0.7	1.9	1.0	2.2	4.8	4.1	3.0	2.5	2.4	2.4
Exchange rate, year-end (LC/$)	3.75	3.46	3.22	3.11	3.52	3.63	3.80	3.80	3.70	3.70
Banks' claims on resident non-gov't sector growth	6.2	4.9	4.8	14.2	13.4	6.0	4.0	5.0	7.0	5.0
Banks' claims on resident non-gov't sector/GDP	70.3	69.8	73.5	74.8	76.1	75.9	76.7	76.8	76.5	75.8
Foreign currency share of claims by banks on residents	4.4	3.7	4.1	3.9	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	19.7	19.1	18.3	19.6	19.5	N/A	N/A	N/A	N/A	N/A

Table 1

Israel--Selected Indicators (cont.)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real effective exchange rate growth	(1.9)	1.1	(3.9)	6.7	4.2	(8.7)	N/A	N/A	N/A	N/A

Sources: The Bank of Israel, Israel Central Bureau of Statistics, International Monetary Fund (Economic Indicators), Israel Central Bureau of Statistics, The Bank of Israel (External Indicators), Bank of Israel and Ministry of Finance of the Government of Israel (Fiscal Indicators), and the Bank of Israel, International Monetary Fund (Monetary Indicators).

Ratings Score Snapshot

Table 2

Israel--Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	4	Generally effective policymaking that promotes sustainable public finance and balanced economic growth. Given that relations between Israeli-Jews, Israeli-Arabs, and Palestinians could be strained, we consider that Israel's civil society is subject to ethnic tensions.
Economic assessment	1	Based on GDP per capita ($), as per the Selected Indicators in Table 1.
External assessment	1	Based on narrow net external debt (% of current account payments) and gross external financing needs (% of current account receipts plus usable reserves), as per the Selected Indicators in Table 1.
Fiscal assessment: flexibility and performance	5	Based on the change in net general government debt (% of GDP), as per the Selected Indicators in Table 1.
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenue) as per the Selected Indicators in Table 1.
Monetary assessment	2	Managed-float exchange-rate regime. The central bank has a track record of operational independence. It uses market-based monetary instruments and has the ability to act as a lender of last resort. Consumer price index, as per the Selected Indicators in Table 1; the local currency financial and capital markets are deep.
Indicative rating	aa-	
Notches of supplemental adjustments and flexibility	-2	Exceptionally material geopolitical risk stemming from confrontation with Hezbollah and risks of more direct conflict with Iran.
Final rating		
Foreign currency	A	
Notches of uplift	0	Default risks do not apply differently to foreign-and local-currency debt.
Local currency	A	

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings History, Sept. 10, 2024
- Sovereign Ratings List, Sept. 10, 2024
- Sovereign Ratings Score Snapshot, Sept. 5, 2024
- Sovereign Risk Indicators, July 8 , 2024. Interactive version available at http://www.spratings.com/sri

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Downgraded; Ratings Affirmed

	To	From
Israel		
Sovereign Credit Rating	A/Negative/A-1	A+/Negative/A-1

Downgraded; Ratings Affirmed

	To	From
Transfer & Convertibility Assessment	AA-	AA
Senior Unsecured	A	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.