Rating Action: Moody's downgrades Israel's ratings to A2, changes outlook to negative; concludes the review

09 Feb 2024

London, February 09, 2024 – Moody's Investors Service (Moody's) has today downgraded Government of Israel's foreign-currency and local-currency issuer ratings to A2 from A1. Moody's has also downgraded Israel's foreign-currency and local-currency senior unsecured ratings to A2 from A1 and the foreign-currency senior unsecured shelf and senior unsecured MTN programme ratings to (P)A2 from (P)A1. The outlook is negative. Previously, the ratings were on review for downgrade. This concludes the review for downgrade initiated by Moody's on 19 October 2023.

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 of America (Aaa negative) with the government acting through USAID. The notes benefit explicitly from "the full faith and credit of the US" and as per prospectus, USAID is obligated to pay within three business days if the guarantee is called upon.

The main driver for the downgrade of Israel's rating to A2 is Moody's assessment that the ongoing military conflict with Hamas, its aftermath and wider consequences materially raise political risk for Israel as well as weaken its executive and legislative institutions and its fiscal strength, for the foreseeable future.

While fighting in Gaza may diminish in intensity or pause, there is currently no agreement to end the hostilities durably and no agreement on a longer-term plan that would fully restore and eventually strengthen security for Israel. The weakened security environment implies higher social risk and indicates weaker executive and legislative institutions than Moody's previously assessed. At the same time, Israel's public finances are deteriorating and the previously projected downward trend in the public debt ratio has now reversed. Moody's expects that Israel's debt burden will be materially higher than projected before the conflict.

The A2 rating also takes into account the sovereign's long-standing strengths including very high economic strength, derived from a diversified, high-income and resilient economy; very high monetary policy effectiveness, recently illustrated by the central bank's ability to swiftly stabilise financial markets; a solid banking sector and the government's very strong liquidity position and market access. These strengths are moderated by fiscal and debt metrics which, already prior to the conflict were weaker than many similarly-rated sovereigns.

The negative outlook reflects Moody's view that downside risks remain at the A2 rating level. In particular, the risk of an escalation involving Hezbollah in the North of Israel remains, which would have a potentially much more negative impact on the economy than currently assumed under Moody's baseline scenario. Government finances would also be under more intense pressure in such a scenario. More generally, the consequences of the conflict in Gaza for

Israel's credit profile will unfold over a long period of time. The negative impact on the country's institutions and/or public finances outlined above may prove more severe than Moody's currently assesses.

Moody's maintained Israel's local-currency country ceiling at Aaa. The five-notch gap between the local-currency ceiling and the sovereign rating balances the limited government footprint in the diversified Israeli economy and external stability against elevated geopolitical risks. The foreign-currency country ceiling has also been maintained at Aaa, in line with the local-currency ceiling, and reflects very low transfer and convertibility risks, given the very open capital account, the central bank's very large foreign currency buffers of 39% of GDP as well as solid policy effectiveness.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADE TO A2

ELEVATED POLITICAL RISKS ARE LIKELY TO PERSIST, WEAKENING EXECUTIVE AND LEGISLATIVE INSTITUTIONS

One key driver for the downgrade of the ratings to A2 is that Israel's elevated exposure to political risks will likely persist for the foreseeable future, even through a reduction in the intensity of or pause in fighting in Gaza.

While there are currently negotiations underway to secure the release of the hostages against a temporary ceasefire and more humanitarian aid into Gaza, there is no clarity on the likelihood, time frame and durability of such an agreement. Also, the governments of the United States and neighbouring countries have presented the broad outlines of a longer-term plan that would include a new governance and political leadership framework in Gaza, which in turn could contribute to improved security for Israel. However, the Israeli government has so far rejected such plans. Moreover, even if a plan is eventually agreed, its durable success will be, for a long time, highly uncertain. As such, Moody's assesses that geopolitical risk and, in particular security risk, will remain materially higher for Israel into the medium to long term. Equally, Israel may face a period of elevated domestic political upheaval and renewed polarisation when the war cabinet dissolves.

Heightened security risks relate to higher social risk for Israel. In turn, this environment weakens the country's institutions, in particular the executive and legislative which, for the foreseeable future, will dedicate significant institutional capacity to restoring security. Moody's assessment also takes into account the strong track record and recent indications of the strength of civil society and the judiciary, which have shown to provide strong checks and balances. The Supreme Court cancelled the government's attempt to restrict judicial overview, underlining the strength and independence of the judiciary. Moreover, the strength of civil society has been on display since the start of the military conflict.

ISRAEL'S PUBLIC FINANCES ARE WEAKER THAN ASSUMED BEFORE THE CONFLICT

Over the coming years, Israel's budget deficit will be significantly larger than expected before the conflict. The Bank of Israel estimates the cost of the conflict for the years 2023-2025 to stand at around NIS 255 billion or around 13% of (2024 forecast) GDP, which includes both higher defense and civilian spending as well as lower tax revenues. The interest bill will also be permanently higher. According to the Ministry of Finance, spending will be permanently higher

by at least 1.4% of GDP and potentially closer to 2% of GDP if the conflict lasts longer or escalates further than currently expected.

In its baseline scenario, Moody's expects Israel's defense spending to be nearly double the level of 2022 by the end of this year and to continue to rise by at least 0.5% of GDP in each of the coming years, with risks tilted towards yet higher defense spending. The 2023 budget deficit was raised from less than 2% of GDP to 4.2% of GDP in the supplementary budget approved in mid-December. The revised 2024 budget sets a deficit of 6.6% of GDP (versus a pre-conflict forecast of around 2.5%).

These estimates take into account a number of mitigating measures. The 2024 budget incorporates a series of deficit-reducing measures, for 2024 and the following years. The single-most important measure is a VAT rate increase by one percentage point next year, which is estimated to bring additional revenues of 0.35% of GDP per year. In total, the government aims to legislate deficit-reducing measures of around 1.1% of GDP both on the revenue and spending side for 2025, with measures of a similar magnitude targeted to remain in place over the following years. If approved in full, these measures could broadly compensate the higher defense and interest spending, although budget deficits will remain much wider than expected before the conflict. The government's willingness to raise taxes is a positive sign about the strength of the country's institutions, given the reluctance of successive governments in th past to consider higher taxes.

Still, as a result of much higher budget deficits, Israel's government debt ratio will rise to a peak of 67% of GDP by 2025 from 60% in 2022. Before the conflict started, Moody's expected that Israel's debt burden would decline towards 55% of GDP.

RATIONALE FOR NEGATIVE OUTLOOK

At the A2 rating level, downside risks remain.

In particular, Moody's considers that the risk of an escalation of the conflict remains significant, especially one involving Hezbollah to the North of Israel, notwithstanding awareness of the very negative consequences of a full-scale conflict on both sides. Conflict with Hezbollah would pose a much bigger risk to Israel's territory, including material damage to infrastructure, renewed calls on reservists and further delays to the return of the evacuees to the region. The Ministry of Finance estimates that real GDP could contract by up to 1.5% overall this year if this downside scenario materialized compared with positive growth of 1.6% under a status quo scenario.

So far the economy has managed the fall-out from the conflict reasonably well, with high-frequency indicators pointin to a swift rebound over the past three months. The labour force is approaching pre-conflict levels, as schools reopened and reservists have started to be released from duty. That said, some sectors of the economy, in particular construction which relies to an important extent on workers from the West Bank, are operating at much lower levels than normal. Under a scenario of outright conflict in the North, the negative economic impact would spread to more sectors and be longer-lasting. Government finances would also be under more intense pressure in such a scenario, as defense spending would likely be even higher than currently assumed.

More generally, the consequences of the conflict in Gaza for Israel's credit profile will unfold over a long period of time, potentially well beyond the period of active fighting. The negative impact on the country's institutions and public finances outlined above may prove more severe than Moody's currently assesses.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Israel's ESG Credit Impact Score at CIS-3 reflects elevated social risks linked to the current conflict and Israel's weakened security environment and to a lesser extent environmental risks which are mitigated to some extent by governance considerations.

Israel has moderate exposure to environmental risks, reflecting primarily physical climate risks and more specifically water stress risk. 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).

Moody's recently lowered its assessment of Israel's exposure to social risks (S-4), to reflect the negative impact of the conflict on its assessment of the country's health and safety situation, as well as risks related to longer-term demographic changes and their impact on the labour market. A lasting solution to the conflict with Hamas is not assured and the security of Israel's population is less established than assumed before the Hamas attacks. Civil society has proven to be resilient to previous episodes of conflict and indications so far suggest that this remains the case. However, combined with the long-standing challenges with regards to demographics – in particular large differences among the country's different population groups with respect to labour market participation rates, income, skill and productivity levels - social risks are material, reflected in a highly negative social IPS score.

Governance considerations mitigate the above social and environmental risks to some extent, reflected in a positive governance and institutions score (G-1). Civil society and the independent judiciary have proven to provide strong checks and balances in Israel's institutional structure. The country's macroeconomic and monetary policy framework is sound and has supported timely policy interventions. In the past, Israel conducted independent inquiries into major security failings and also established a commission to assess the country's longer-term defense needs, which were important signals for high levels of transparency and disclosure.

By virtue of the ratings having been on review for downgrade, the conclusion of the review deviates from the previousl scheduled dates announced in the EU Sovereign Release Calendar, published on https://ratings.moodys.com.

GDP per capita (PPP basis, US$): 51,990 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 6.5% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5.3% (2022)

Gen. Gov. Financial Balance/GDP: 0.4% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: 3.9% (2022) (also known as External Balance)

External debt/GDP: 29.7% (2022)

Economic resiliency: a1

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

On 06 February 2024, a rating committee was called to discuss the rating of the Israel, Government of. The main points raised during the discussion were: The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The systemic risk in which the issuer operates has materially increased.

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

Given the negative outlook, an upgrade to the rating is unlikely. Moody's would stabilize the outlook if there was evidence that Israel's institutions are able to formulate policies that support the economic and public finance recovery and restore security while dealing with a wide range of policy priorities.

The ratings would likely be downgraded if the situation in the North escalated to a full-scale conflict with Hezbollah with a significantly more negative impact on Israel's infrastructure and ability of the economy to recover. Indications that Israel's institutional capacity is more diminished than Moody's currently assesses by the need to focus on the country's security would also be negative. Moreover, an increasing likelihood of a materially larger negative impact on the sovereign's economic and fiscal strength over the medium term than Moody's currently projects would also put downward pressure on the rating.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/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.

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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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