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Fitch Upgrades Israel To 'A'; Outlook Stable

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Fitch Ratings-London-11 February 2008: Fitch Ratings has today upgraded the State of Israel's foreign currency Issuer Default rating ("IDR") to 'A' from 'A-' (A minus) and the local currency IDR to 'A+' from 'A'. Following the upgrade, the Outlooks on both ratings are now Stable. The Country Ceiling is also upgraded to 'AA-' (AA minus) from 'A+'. The Short-term foreign currency IDR is affirmed at 'F1'.

"The upgrade reflects the rapid fall in the all-important ratio of public debt/GDP, which reached an all-time low of just over 80% last year," said Richard Fox, Head of Middle East and Africa Sovereign Ratings at Fitch. "Although still high, we expect further reductions in the debt ratio in the year ahead, despite likely slower economic growth due to the global slowdown."

Israel's high public debt ratio has long constrained its ratings. However, the fiscal framework put in place since the recession of 2001/2, combined with other important economic and structural reforms that have revitalised growth, has delivered a cumulative four-year fall in the debt ratio by over 20% of GDP, to reach an all time low of just over 80% last year. The headline 'state' budget deficit was in virtual balance in 2007, also for the first time ever. Although the debt ratio remains high relative to rated peers in the 'A' category, it is no longer the highest in what is a wide range, spanning Estonia's 3% of GDP and Greece's 94%. Fitch continues to believe that Israel needs a lower debt ratio than its peers due to its vulnerability to security shocks. However, the agency also gives weight to several mitigating factors. Almost a quarter of the debt represents non-tradable debt issued to pension funds in successive reforms that have left Israel's unfunded pension liabilities amongst the lowest of OECD countries, which the country will soon join. As regards the external debt, almost half attracts a US government guarantee and a further third is held as State of Israel Bonds by the Jewish diaspora, demand from which has always increased at times of stress.

GDP has grown by 5.25% in each of the past four years, responding to structural reforms introduced by successive administrations since 2003. Growth will likely slow this year, however, in response to the global slowdown. The severity of the slowdown remains to be seen but Fitch takes comfort from the fact that even assuming Israeli growth of only 3.5% - which is at the bottom of the range of available forecasts - the debt ratio continues to fall and the overall general government deficit remains contained. A cap on real government spending growth has been instrumental in the marked fiscal consolidation seen over the past four years. A debate is now ongoing over possible revisions to fiscal rules. Fitch understands the aim is to preserve hard-won, but still relatively short-lived, fiscal credibility and preserve operational simplicity and effectiveness while making room for necessary public spending. Israel's general government spending is nearing the OECD average, despite higher-than-average military and interest spending. More prominence may also be given to the debt ratio, which Fitch would encourage. While keenly interested in the outcome of the debate, Fitch does not expect it to have a major impact on the positive debt dynamics now established. Rating upside hinges on Israel reducing the debt ratio closer to the 50% average for countries with similar income per capita income and the 30% median for 'A' rated peers.

Other indicators have long supported Israel's ratings. These include a per capita income that is well ahead of the 'A' median and exceeds many countries in the 'AA' category. World Bank governance indicators are also solidly in the 'A' category range and the net external creditor and current account positions are well ahead of 'A' and even 'AA' medians.

The other main constraint on the ratings is security threats which, as demonstrated in 2001-2, have the potential to derail the economy. On the other hand, the security fence has reduced terrorism and the economy has grown strongly despite the disruption caused by the Lebanon war and the regular missile attacks from Gaza. Although threats remain, US political, financial and military support provides important mitigation.

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